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Cross-Complainants City of San José  
9 and Debra Figone, in her official capacity

(ENDORSED)  
**FILED**  
FEB - 7 2013  
DAVID H. YAMASAKI  
Chief Executive Officer/Clerk  
Superior Court of CA County of Santa Clara  
BY \_\_\_\_\_ DEPUTY

10 **IN THE SUPERIOR COURT FOR THE**  
11 **COUNTY OF SANTA CLARA**

12 SAN JOSE POLICE OFFICERS  
ASSOCIATION,

13 Plaintiff,

14 v.

15 CITY OF SAN JOSE, BOARD OF  
16 ADMINISTRATION FOR POLICE AND  
FIRE RETIREMENT PLAN OF CITY OF  
17 SAN JOSE, and DOES 1-10 inclusive.,

18 Defendants.

19 AND RELATED CROSS-COMPLAINT  
20 AND CONSOLIDATED ACTIONS

Case No. 1-12-CV-225926

By Fax

[Consolidated with Case Nos. 112CV225928,  
112CV226570, 112CV226574, 112CV227864]

**DECLARATION OF ALEX GURZA IN  
SUPPORT OF DEFENDANTS' AND  
CROSS-COMPLAINANT'S MOTION FOR  
SUMMARY ADJUDICATION**

**VOLUME 1**

**EXHIBITS 1 THROUGH 8**

Date: April 23, 2013

Time: 9:00 a.m.

Dept.: 8

Complaint Filed: June 6, 2012

Trial Date: None Set

23 I, ALEX GURZA, declare:

24 1. I am a Deputy City Manager and the Director of the Office of Employee Relations  
25 in the City Manager's Office for the City of San Jose (hereinafter, "City"). I submit this  
26 declaration in support of the City's Motion for Summary Adjudication. I have personal  
27 knowledge of the facts set forth below and if called as a witness I could and would testify  
28 competently thereto.

Case No. 112CV225926

DECLARATION OF ALEX GURZA IN SUPPORT OF CITY OF SAN JOSE'S MOTION FOR SUMMARY  
ADJUDICATION

2. I have been employed by the City of San Jose in the Office of Employee Relations since October 3, 1994. During that time, I have been responsible for the formulation of City policies in connection with employee compensation and benefits and for the negotiation of wages, benefits and other terms and conditions of employment with the labor unions that represent City employees.

### The City of San Jose's Workforce

3. The City employs approximately 5400 full-time equivalents ("FTEs"); FTEs are the combined total number of budgeted full-time positions. For example, one full-time position equals one FTE, and two half-time positions equal one FTE. The majority of the workforce is organized. The following labor unions represent City employees:

- Association of Building, Mechanical and Electrical Inspectors (ABMEI) – approximately 67 FTEs.
- Association of Engineers and Architects (AEA), IFPTE Local 21 (Units 041, 042 and 043) – approximately 214 FTEs
- Association of Legal Professionals (ALP) – approximately 36 FTEs
- Association of Maintenance Supervisory Personnel (AMSP), IFPTE Local 21 – approximately 78 FTEs
- City Association of Management Personnel (CAMP), IFPTE Local 21 – approximately 329 FTEs
- Confidential Employees' Organization (CEO), AFSCME Local No. 101 – approximately 189 FTEs
- International Association of Firefighters (IAFF), Local 230 – approximately 646 FTEs
- International Brotherhood of Electrical Workers (IBEW), Local 332 – approximately 73 FTEs
- International Union of Operating Engineers, Local No. 3 (OE#3) – approximately 664 FTEs
- Municipal Employees' Federation (MEF), AFSCME Local 101 – approximately 1851 FTEs
- San Jose Police Officers' Association (SJPOA) – approximately 1107 FTEs

4. The City workforce also includes two units of unrepresented employees, the Executive Management and Professional Employees (Unit 99), and Other Unclassified Non-

1 Management Employees (Units 81 and 82).

2 5. The City establishes terms and conditions of employment with its labor unions  
3 through collective bargaining. Periodically, the City and labor unions enter into Agreements,  
4 which are ratified by the union membership and approved by the City Council through enactment  
5 of resolutions. If the City and labor unions cannot come to agreement, the City may implement  
6 after impasse procedures the City's Last, Best and Final Offer ("LBF") by City Council resolution,  
7 except that if the City and the unions representing police officers and firefighters do not come to  
8 an agreement, depending on the issue, the City Charter provides for interest arbitration to resolve  
9 the dispute. For unrepresented employees, the City Council establishes compensation by  
10 resolution. Retirees are not represented by any City labor union.

11 **Plaintiffs In This Case**

12 6. Plaintiffs in these five consolidated cases are either City labor unions or current and  
13 retired former members of City labor unions, including:

- 14 • Plaintiffs in the *Mukhar* case are current and retired former members of the  
15 Association of Engineers and Architects [Mukhar is president of AEA], and  
16 Association of Maintenance Supervisory Personnel ([Dapp is president of  
17 AMSP].
- 18 • Plaintiffs in the *Sapien* case are current and retired former members of the  
19 International Association of Firefighters (IAFF), Local 230.
- 20 • Plaintiffs in the *Harris* case are current and retired former members of the  
21 International Union of Operating Engineers, Local No. 3 (OE#3).
- 22 • Plaintiff AFSCME is a labor union representing two City bargaining units  
(Municipal Employees' Federation [MEF] and Confidential Employees'  
23 Organization [CEO]).
- 24 • Plaintiff SJPOA is a City labor union.

25 **City Retirement Plans**

26 7. The City has two retirement plans, the Police and Fire Department Retirement Plan,  
27 for police officers and firefighters, and the Federated City Employees' Retirement System, for all  
28 other employees. The provisions for these plans are established in the City Charter, City  
Municipal Code and agreements with labor unions. The plans include both pension and retiree  
health benefits. The plans are administered by two independent retirement boards, which invest

1 retirement funds, contract for audit and actuarial services, issue financial reports and determine  
2 employee eligibility for benefits.

3 8. Based on actuarial reports, the boards establish yearly contribution rates to be paid  
4 by employees and the City, as a percentage of salary, to fund employee retirement benefits.  
5 Although the independent retirement boards determine the yearly contributions needed to fund the  
6 plans, the Charter, Municipal Code and agreements with unions determine how contributions are  
7 to be divided between employees and the City.

8 Measure B

9 9. Beginning in 2009, the City's contributions for retiree pensions began to  
10 dramatically increase and create significant deficits in the City budget. In September 2010, the  
11 City's Auditor released a report entitled "Pension Sustainability: Rising Pension Costs Threaten  
12 The City's Ability To Maintain Service Levels – Alternatives For A Sustainable Future." The  
13 Auditor's Report contained a number of recommendations to reform the City's retirement systems  
14 and decrease costs. A true and correct copy of the Auditor's report is attached as Exhibit 1.

15 10. In May 2011, the City Manager released the Fiscal Reform Plan with  
16 recommendations to achieve cost reductions and/or new revenues for the General Fund to allow  
17 for a restoration of services, including addressing increasing retirement costs.

18 11. In 2011, the City began to meet and confer with City unions over a plan to amend  
19 the City Charter to reform the City's retirement systems. Under the requirements of *Seal Beach*  
20 *Police Officers' Assn. v. City of Seal Beach*, 36 Cal. 3d 591 (1984), the City met and conferred for  
21 over a year but ultimately did not reach any consensus with unions over retirement reform  
22 measures.

23 12. In March 2012, the City Council voted to place Measure B on the ballot to amend  
24 the City Charter's retirement provisions. In June 2012, the voters enacted Measure B by  
25 approximately 70 percent in favor of Measure B. Soon after, City labor unions, employees and  
26 retirees filed the five actions that were later consolidated under the caption for this case.

27 13. Measure B contains provisions that address employee contributions to pension and  
28 retiree health benefits, the creation of alternative pension plans, the end of a supplemental retiree

1 benefit reserve, disability retirement requirements, and suspension of cost of living increases in the  
2 event of an emergency, among other issues.

3 **Employee Contributions Towards Pension Plans**

4 14. Measure B requires employees to make additional pension contributions to the  
5 retirement system to defray pension plan unfunded liabilities unless they voluntarily elect to enroll  
6 in an alternative lower cost plan. Specifically, Measure B Section 1506-A requires employees to  
7 make additional payments in increments of 4% of pensionable pay per year, up to a maximum of  
8 16% of pensionable pay per year, but no more than 50% of the costs per year to amortize any  
9 pension plan unfunded liabilities. (Section 1506-A). These contributions are credited to  
10 employees' retirement accounts.

11 15. Prior to the enactment of Measure B, City employees made "additional" pension  
12 contributions under agreements between the City and its labor unions for the purpose of paying  
13 towards the City's unfunded pension liabilities. City employees also made, or were required by  
14 the City to make, wage concessions as an alternative to making additional pension contributions.  
15 The City considers retirement contributions, wages and other benefits to be part of "Total  
16 Compensation" for City employees. "Total Compensation" is the total cost to the City of pay and  
17 benefits, including base pay, retirement contributions, health insurance, and other benefits.

18 16. As stated above, in 2009, the City faced significantly increased retirement  
19 contributions towards employee pension benefits and a large deficit caused in large part by the  
20 increased contributions. To mitigate the City's fiscal shortfall, in 2010 the City negotiated with  
21 City unions to achieve a 10% reduction in total compensation for the purpose of reducing the  
22 potentially significant service reduction and layoffs of City employees required to balance the City  
23 budget.

24 17. In 2010, a coalition of City unions proposed that the City achieve this  
25 compensation reduction by employees making an "additional" pension contribution to defray the  
26 City's required pension contributions. This coalition consisted of AEA, ABMEI, AMSP, CAMP,  
27 IBEW and OE#3 ("Coalition"). (Plaintiffs in the *Mukhar* case are members and/or former  
28 members of AEA and AMSP [Plaintiff Mukhar is president of AEA, plaintiff Dapp is president of

1 AMSP], and plaintiffs in the *Harris* case are members and/or former members of OE#3.)

2 18. The SJPOA and IAFF also offered proposals to achieve compensation reduction via  
3 employees making an "additional" pension contribution to defray the City's required pension  
4 contributions. (The SJPOA is plaintiff in the *SJPOA* case; plaintiffs in the *Sapien* case are  
5 members and/or former members of IAFF.)

6 19. The Coalition unions took the position that the additional employee retirement  
7 contribution of 10% could be authorized by an amendment to the Municipal Code and did not  
8 violate the City Charter. An initial proposal received from the Coalition stated:

9 5.1.2. Additional Retirement Contribution.

10 Effective June 27, 2010 through June 28, 2011, all employees will  
11 make additional retirement contributions in an amount equivalent to  
12 10% of total compensation effective June 27, 2010. The amounts so  
13 contributed will be applied to subsidize and thus reduce the prior  
14 service contributions that the City would otherwise be required to  
15 make. The parties specifically understand that this agreement  
16 neither alters nor conflicts with the City Charter Section 1505(c)  
17 because under this agreement, employees will be subsidizing the  
18 City's Section 1505(c) required contribution. This employee  
19 retirement contribution is in addition to and apart from the employee  
20 retirement contribution rates established and approved by the  
21 Federated City Employees' Retirement System Board. This  
22 additional employee contribution shall be reduced by half (50%)  
23 effective the first payroll period for Fiscal Year 2012.

24 \* \* \* \*

25 In order to implement this provision, the City may be required to  
26 amend the Federated City Employees' Retirement System by  
27 adopting an ordinance amending the San Jose Municipal Code.  
28 These contributions shall be treated in the same manner as any other  
employee contributions. Accordingly, these additional employee  
contributions will be made on a pre-tax basis through payroll  
deductions pursuant to IRS Code Section 414(h)(2) and will be  
subject to withdrawal, return and redeposit in the same manner as  
any other employee contributions.

29 A true and correct copy of the Coalition proposal provided to the City, dated 6/18/10, 4:25  
30 p.m., is attached as Exhibit 2. True and correct copies of additional union proposals by Coalition  
members and by the SJPOA and IAFF to pay an increased employee contribution rate are attached  
as Exhibits 3 thru 6.

1       20.     During the negotiations over the payment of the additional pension contributions,  
2 representatives of the Coalition unions and the City, including myself, discussed the legality of the  
3 additional contributions under the City Charter. Under the City Charter, the contribution rate to  
4 pay for "current service or current service benefits" may not exceed the ratio of 3 for employees to  
5 8 for the City, but the contribution rate to pay for "prior service or prior service benefits" is not  
6 subject to any ratio. The Coalition unions took the position that the additional retirement  
7 contributions for unfunded liabilities were to pay for "prior service" which is not subject to the 3  
8 to 8 ratio under the Charter. Thus, the unions took the position that the employees could pay the  
9 entire pension contribution required for the unfunded liabilities.

10       21.     In a letter dated June 17, 2010, the Coalition unions transmitted copies of their  
11 proposal to make the additional pension contributions to the Mayor and City Council. A true and  
12 correct copy of the letter and attached agreements that we received is attached as Exhibit 7.

13       22.     During the City Council hearing on the proposal for employees to make additional  
14 pension contributions, Christopher Platten, an attorney representing members of the Coalition,  
15 stated the position of his clients that the City Charter was not a barrier to employees paying the  
16 increased contribution rates. A transcript of his comments are attached as Exhibit 8.

17       23.     For the three year period, 2010, 2011 and 2012, the union Agreements or Last Best  
18 and Final Offers, with authorizing resolutions, are attached as Exhibits 9 thru 34 in alphabetical  
19 order by union. The memoranda from myself and other City employees in connection with the  
20 City resolutions contained in Exhibits 9 thru 34 were made by and within the scope of the  
21 employees' public duties, were made at or near the time of the act, condition or event described in  
22 the memoranda, and reflect information from City financial and collective bargaining records.

23       24.     During fiscal year 2010-2011, the following six unions agreed that their members  
24 would pay additional employee pension contributions, both ongoing and one-time, as well as a  
25 one-time base pay reduction, equivalent to approximately 10% of total compensation, except the  
26 POA agreed that its members would pay 5.25% in additional employee pension contributions on a  
27 one-time basis. The additional contributions and pay reductions were to be used to defray pension  
28 plan unfunded liabilities.

- Association of Engineers and Architects (AEA) (plaintiff Mukhar, lead plaintiff in the *Mukhar* case, is president of the union). [Exhibit 11]
- Association of Maintenance Supervisory Personnel (AMSP) (plaintiff Dapp, a plaintiff in the *Mukhar* case, is president of the union). [Exhibit 15]
- City Association of Management Personnel (CAMP). [Exhibit 17]
- International Brotherhood of Electrical Workers, Local 332 (IBEW). [Exhibit 23]
- Operating Engineers, Local No. 3 (OE#3) (which represents plaintiffs in the *Harris* case). [Exhibit 25]
- San Jose Police Officers' Association (SJPOA) (plaintiff in the *SJPOA* case). [Exhibit 29]

True and correct copies of the Agreements, and authorizing resolutions are attached as indicated above next to each union.

25. The following unions or groups agreed to a wage reduction rather than paying additional employee pension contribution rates, or the City imposed a wage reduction in the form of a Last Best and Final Offer or by resolution:

- Association of Building, Mechanical and Electrical Inspectors (ABMEI). [Exhibit 9]
- Association of Legal Professionals (ALP). [Exhibit 13]
- Executive Management and Professional Employees (Unit 99). [Exhibits 32, 33]
- Other Unclassified Non-Management Employees (Units 81 and 82). [Exhibit 32, 33]

True and correct copies of these Agreements or Last Best and Final Offers, and authorizing resolutions, are attached as indicated above next to each union.

26. Only three bargaining units did not come to an agreement with the City during 2010-2011. The International Association of Firefighters (IAFF), Local 230, which represents plaintiffs in the *Sapien* case) had a Memorandum of Agreement (MOA) that expired in 2009, did



1 not come to any agreement with the City during 2010-2011, but came to an agreement with the  
2 City in 2011 to take an approximate ongoing 10% wage reduction. (Exhibit 21) Confidential  
3 Employees' Organization (CEO), AFSCME Local 101 (Exhibit 20) and Municipal Employees'  
4 Federation (MEF), AFSCME Local No. 101 (represented by plaintiff in the *AFSCME* case)  
5 (Exhibit 28) had a closed contract in 2010-2011, but in 2011-2012 the City imposed an  
6 approximate 12% wage reduction as part of the City's Last, Best and Final Offer. True and  
7 correct copies of these Agreements or Last Best and Final Offers, with authorizing resolutions, are  
8 attached as Exhibits 20, 21, and 28.

9       27. The union agreements to pay additional employee pension contributions contained  
10 substantially similar provisions. For example, the 2010-2011 MOA between the City and the  
11 Association of Engineers and Architects (AEA Unit 43), of which plaintiff Mukhar is the  
12 president, states at Section 10.1.1:

13               On-Going Additional Retirement Contributions. Effective June 27,  
14 2010, all employees who are members of the Federated City  
15 Employees' Retirement System will make additional retirement  
16 contributions in the amount of 7.30% of pensionable compensation,  
17 and the amounts so contributed will be applied to **reduce the**  
18 **contributions that the City would otherwise be required to make**  
19 **for the pension unfunded liability**, which is defined as all costs in  
20 both the regular retirement fund and the cost-of-living fund, except  
21 current service normal costs in those funds. This additional  
employee retirement contribution would be in addition to the  
employee retirement contribution rates that have been approved by  
the Federated City Employees' Retirement System Board. **The**  
**intent of this additional retirement contribution by employees is**  
**to reduce the City's required pension retirement contribution**  
**rate by a commensurate 7.30% of pensionable compensation, as**  
**illustrated below ...**": [Emphasis added]

22       In addition, the union agreed to an additional one-time additional pension contribution "in  
23 the amount of 3.53% of pensionable compensation, and the amounts so **contributed will be**  
24 **applied to reduce the contributions that the City would otherwise be required to make**  
25 **during that time period for the pension unfunded liability....**" (Section 10.1.2) [Emphasis  
26 added]

27       28. The unions also agreed to the City amending the Municipal Code to provide for the  
28 payment by employees of these "additional contributions." The AEA agreement stated: "The

1 parties understand that in order to implement this provision, an amendment must be made to the  
2 Federated City Employees' Retirement System that requires an ordinance amending the San Jose  
3 Municipal Code." (Exh. 11 at Section 10.1.4.) The POA agreement stated: "The parties  
4 understand that in order to implement this provision, an amendment must be made to the Police &  
5 Fire Department Retirement Plan that requires an ordinance amending the San Jose Municipal  
6 Code." (Exh. 29 at p. 3 of POA's Memorandum of Agreement.) See Exhibits 11, 15, 17, 23, 25,  
7 and 29.

8       29. As agreed with the unions, the City amended the Municipal Code provisions for  
9 both the Federated Plan and Police and Fire Plans to authorize payment by employees of  
10 additional pension contributions and provide that these contributions could be used to offset the  
11 City's pension contributions. (See Municipal Code 3.28.775, 3.28.955 [Federated], 3.36.1525  
12 [Police and Fire].)

13       30. Most of the additional employee contributions and/or wage reductions for fiscal  
14 year 2010-2011 equaled approximately 10% of employee total compensation. In the following  
15 two fiscal years, 2011-2012 and 2012-2013, the unions that had agreed to the additional employee  
16 contributions agreed to take the 10% reduction in total compensation as a straight wage reduction,  
17 and other unions agreed to take or continue to take wage reductions. For those unions that did not  
18 agree, the City imposed a wage reduction as part of the City's Last, Best and Final Offer. True and  
19 correct copies are attached as Exhibits 10, 12, 14, 16, 18, 20, 22, 24, 26, 28, 30, 31, and 34.

20       31. During negotiations over compensation, the City and its employee unions have  
21 treated increased employee pension contribution rates as interchangeable with wage decreases.  
22 Both are elements that reduce "Total Compensation," which is the total cost to the City of pay and  
23 benefits, including base pay, retirement contributions, health insurance, and other benefits.  
24 Increased employee pension contributions have some advantages over wages for employees. The  
25 deductions are made pre-tax and are credited to the employee's retirement account, which means  
26 that if the employee leaves employment with the City, the employee has the option of taking the  
27 balance of the retirement account. During the later negotiations, the City received an e-mail from  
28 a union representative making these points. A true and correct copy is attached as Exhibit 35.

**Employee Contributions Towards Retiree Healthcare**

32. Measure B requires that: "Existing and new employees must contribute a minimum of 50% of the cost of retiree healthcare, including both normal cost and unfunded liabilities." (Section 1512-A: Retiree Healthcare.)

33. Under the Municipal Code, the City's retirement plans subsidize retiree health care premiums for eligible retirees who have 15 or more years of service with the City. The retirement plans pay 100% of the premium for the lowest cost plan, offered by the City, for either single or family coverage. Payments for retiree medical premiums are made from a retirement system medical benefits fund, or a trust fund, which are accounted for separately from the pension funds.

34. In the case of both the Federated and the Police and Fire Retirement Plans, the Municipal Code requires that employees and the City make contributions towards retiree medical benefits on a one to one ratio. (Municipal Code 3.28.385(C); 3.36.575(D).)

35. Contribution rates for retiree healthcare benefits, which are separate from pension contribution rates, are established by the independent retirement boards based on data from the board's actuary. Historically, the contributions from employees and the City did not fully prefund the cost of employee retiree healthcare benefits. In 2007, the City began to address the new GASB reporting standards that required state and local governments to disclose the full cost of "unfunded actuarial liabilities" for "Other Post-Employment Benefits" ("OPEB") such as retiree healthcare.

36. Actuarial studies reported the City's unfunded liability for retiree health care to be as high as \$1.65 billion, if it did not prefund the health care costs, and \$1.14 billion if it fully prefunded the costs. Attached as Exhibit 36 is a true and correct copy of a Memorandum dated July 24, 2007, from myself and others to Mayor and City Council, regarding "Retiree Healthcare." The memorandum attaches true and correct copies of reports received by the City from two actuaries: Report from Bartel Associates, LLC, re "Retiree Healthcare Plan, June 30, 2007, Federated City Employees"; Letter from Segal Company, dated January 12, 2007, Re Police and Fire Plan GASB Results. True and correct copies of the reports are attached as Exhibits 37 and 38.

37. After receipt of these reports, the City Council directed City staff to begin

1 negotiations with City unions over contributions towards payment of the full "Annual Required  
2 Contribution" ("ARC") - the contribution needed on an annual basis in order to cover the  
3 estimated costs of the retiree health care benefit for current and future retirees. The ARC is  
4 expressed as both a dollar amount and as a percentage of payroll.

5 38. Beginning in 2009, the City reached agreement with most City unions for  
6 employees and the City to continue paying the cost of retiree healthcare on a one-to-one ratio, and  
7 to phase in additional employee and City contributions, in the same ratio, to eventually fully fund  
8 the ARC.

9 39. The City reached agreements with the following unions:

- 10 • Association of Building, Mechanical and Electrical Inspectors (ABMEI);
- 11 • Association of Engineers and Architects, IFPTE Local 21 (AEA Units 41/42  
12 and 43) (plaintiff Mukhar, lead plaintiff in the *Mukhar* case, is president of the  
13 union);
- 14 • Association of Maintenance Supervisory Personnel, IFPTE Local 21 (AMSP)  
(plaintiff Dapp, a plaintiff in the *Mukhar* case, is president of the union);
- 15 • City Association of Management Personnel, IFPTE Local 21 (CAMP);
- 16 • International Brotherhood of Electrical Workers, Local No. 332 (IBEW);
- 17 • Municipal Employees' Federation, AFSCME Local 101 (MEF) (plaintiff in the  
18 *AFSCME* case);
- 19 • Confidential Employees' Organization, AFSCME Local 101 (CEO);
- 20 • San Jose Police Officers' Association (plaintiff in the *SJPOA* case); and
- 21 • International Association of Firefighters (IAFF), Local 230 (representative for  
22 employee plaintiffs in the *Sapien* case); the agreement with IAFF was reached  
23 in 2011 and the City and employees represented by IAFF began to phase in  
24 additional retiree healthcare contributions starting in 2011.

25 True and correct copies of these Agreements and authorizing resolutions with unions are  
26 attached as Exhibits 39 (agreement covering ABMEI, AEA, AMSP, CAMP, IBEW, MEF, and  
27 CEO), 40 (resolution approving agreement), 41 (resolution and agreement covering POA), and 21  
28 (resolution and agreement covering IAFF).

1           40.     A typical agreement with the Federated unions stated:

2                     The City and the Employee Organization agree to transition from  
3                     the current partial pre-funding of retiree medical and dental  
4                     healthcare benefits (referred to as the "policy method") to pre-  
5                     funding of the full Annual Required Contribution (ARC) for the  
6                     retiree healthcare plan ("Plan"). The transition shall be  
7                     accomplished by phasing into fully funding the ARC over a period  
8                     of five (5) years beginning June 28, 2009. The Plan's initial  
9                     unfunded retiree healthcare liability shall be fully amortized over a  
10                    thirty year period so that it shall be paid by June 30, 2039 (closed  
11                    amortization). ....The City and Plan members (active employees)  
12                    shall contribute to funding the ARC in the ratio currently provided  
13                    under Section 3.28.380(C)(1) and (3) of the San Jose Municipal  
14                    Code. Specifically, contributions for retiree medical benefits shall  
15                    be made by the City and members in the ratio of one-to-one. ...  
16                    (Exh. 39, AEA, MOA, Section 12.1)

17           41.     The payments of the full ARC were to be phased in incrementally but: "[B]y the  
18                    end of the five year phase-in, the City and plan members shall be contributing the full Annual  
19                    Required Contribution in the ratio currently provided under Section 3.28.380 (C) (1) and (3) of the  
20                    San Jose Municipal Code." (Exh. 39, AEA, MOA, Section 12.3)

21           42.     The unions also agreed that amendments to the Municipal Code in accordance with  
22                    this agreement were to be made and that "(t)he City and the Employee Organization further agree  
23                    that the Municipal Code and/or applicable plan documents shall be amended in accordance with  
24                    the above agreement and that the Employee Organization will support such amendments." (Exh.  
25                    39, AEA, MOA, Section 12.2.)

26           43.     This or similar language was agreed to by all Federated unions that are plaintiffs in  
27                    these consolidated actions or who represent individuals who are plaintiffs in these consolidated  
28                    actions, with the exception of the Operating Engineers (OE#3), which represents the *Harris*  
29                    plaintiffs. The City imposed these terms on OE#3 as part of the City's Last, Best and Final Offer.  
30                    True and correct copies of the Last, Best and Final Offer, and authorizing resolutions, are attached  
31                    as Exhibits 42 and 43.

32           44.     The SJPOA and IAFF also agreed to pay towards the full ARC, but with some  
33                    additional provisions. Their respective agreements cap the contribution towards paying the full  
34                    ARC at 10% of pensionable pay for employees and provide for meet and confer and dispute  
35                    resolution procedures for amounts over that percentage. True and correct copies of those

1 Agreements, and authorizing resolutions are attached as Exhibits 41 (POA) and 21 (IAFF).

2 45. The memoranda from myself and other City employees concerning retiree  
3 healthcare benefits and the memoranda concerning or attached to the City's authorizing  
4 resolutions, Exhibits 36 thru 43 and 21, were made by and within the scope of the employees'  
5 public duties, were made at or near the time of the act, condition or event described in the  
6 memoranda, and reflect information from City financial and collective bargaining records.

7 **Supplemental Retiree Benefit Reserve**

8 46. Measure B states, "The Supplemental Retiree Benefit Reserve ("SRBR") shall be  
9 discontinued, and the assets returned to the appropriate retirement trust fund. Any supplemental  
10 payments to retirees in addition to the benefits authorized herein shall not be funded from plan  
11 assets." (Measure B, § 1511-A.)

12 47. Under the Municipal Code, the Supplemental Retiree Benefit Reserve ("SRBR")  
13 was a feature of both the Federated and Police and Fire retirement plans. The SRBR provided  
14 retirees with a so-called "13<sup>th</sup> check" on top of their other existing pension benefits (a monthly  
15 pension; a retirement healthcare premium subsidy; and a 3% yearly COLA.)

16 48. Employee pension contribution rates to the retirement systems have not included  
17 any amounts specifically attributable to the SRBR.

18 49. Beginning in 2009, the retirement funds began to experience significant increases  
19 in unfunded liabilities. The large unfunded liabilities resulted in an anomaly. Although the  
20 retirement systems had large unfunded liabilities, they earned enough in a particular year to have  
21 "excess earnings" for the year – as defined in the Municipal Code – to fund the SRBR. And under  
22 the resolutions that established the methods for distribution to retirees, the SRBR in turn had  
23 sufficient funds to make supplemental distributions to retirees.

24 50. Attached as Exhibit 44 is a true and correct copy of a Memorandum dated October  
25 22, 2010, from Debra Figone, City Manager to Honorable Mayor and City Council re "Suspension  
26 of SRBR Payments."

27 51. Attached as Exhibit 45 is a true and correct copy of a Memorandum dated May 13,  
28 2011 from Debra Figone, City Manager to Honorable Mayor and City Council re "Continued

1 Suspension of SRBR Payments.”

2 52. Attached as Exhibits 46 thru 48 are true and correct copies of a Memorandum dated  
3 April 9, 2012, from Debra Figone, City Manager to Honorable Mayor and City Council re  
4 “Suspension of SRBR Payments” at pp. 4-5 (Exhibit 46); Letter dated January 13, 2012 from  
5 Cheiron re Federated Plan Supplemental Retiree Benefit Reserve as of June 30, 2011 (Exhibit 47);  
6 Letter dated March 29, 2012 from Cheiron re Police and Fire Retirement Plan Supplemental  
7 Retiree Benefit Reserve as of June 30, 2011. (Exhibit 48)

8 53. In the memoranda to the City Council, the City Manager recommended suspension  
9 of SRBR distributions due to “the plans’ significant unfunded liabilities.” The memoranda  
10 attached as Exhibits 44 thru 48 were made by and within the scope of the employees’ public  
11 duties, were made at or near the time of the act, condition or event described in the memoranda,  
12 and contain information obtained from City financial records.

13 54. Beginning in 2010, City Council enacted resolutions to suspend distribution of  
14 Federated SRBR funds for the fiscal years 2010-2011, 2011-2012, and 2012-2013. Beginning in  
15 2010, the Council enacted ordinances to suspend distribution of Police and Fire Plan SRBR funds  
16 for the same fiscal years.

17 55. In 2011, a number of City unions either made proposals or entered into tentative  
18 agreements for the elimination of the SRBR in part or in whole. Attached as Exhibits 49 thru 53  
19 Tentative Agreements with ABMEI (Exhibit 49), IBEW (Exhibit 50), OE#3 (Exhibit 51), CEO  
20 (Exhibit 52), and MEF (Exhibit 53), to eliminate SRBR completely.

21 56. After the enactment of Measure B, the City Council enacted Ordinance Number  
22 29174 amending the Municipal Code to terminate the Federated SRBR and return its funds to the  
23 general retirement fund. The ordinance became effective on January 4, 2013. A true and correct  
24 copy of the Ordinance is attached as Exhibit 54. The City Council also enacted an ordinance  
25 amending the Municipal Code to terminate the Police and Fire SRBR and return its funds to the  
26 general retirement fund. The ordinance was enacted on January 29, 2013, and will become  
27 effective on March 1, 2013. A true and correct copy of this ordinance is attached as Exhibit 55.

28

Retirement System Actuarial Reports

57. The two City retirement systems, and sometimes the City itself, obtain actuarial reports concerning retirement system funds, liabilities and contribution rates to the systems for the City and employees. Attached as Exhibits 56 thru 61 are true and correct copies of the following reports received from system actuaries.

Cheiron, February 8, 2012, Letter to Board of Administration re 5-Year Budget Projections for Federated. [Exhibit 56]

Cheiron, February 21, 2012, Letter to Director of Retirement Services, Police & Fire Department Retirement Plan re 5-Year Budget Projections for Police & Fire. [Exhibit 57]


Cheiron, December 2012, Federated City Employees' Retirement System, June 30, 2012 Actuarial Valuation. [Exhibit 58]

Cheiron, December 2012, City of San Jose Police and Fire Department Retirement Plan, June 30, 2012 Actuarial Valuation. [Exhibit 59]

Cheiron, January 17, 2013, San Jose Federated City Employees' Retirement System, June 30, 2012 OPEB Actuarial Valuation Results. [Exhibit 60]

Cheiron, February 7, 2013, City of San Jose Police and Fire Department Retirement System, June 30, 2012 OPEB Actuarial Valuation Results. [Exhibit 61]

I declare under penalty of perjury under the laws of the State of California that the foregoing is true and correct and that I executed this declaration on February 7th, 2013 in SAN JOSE, California.



Alex Gurza

2046124.1



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TO DECLARATION OF ALEX GURZA**

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2	Coalition of Union proposal offered to City – June 18, 2010 (4:25 p.m.)
3	OE#3 Union Proposals to City to pay increased employee contribution rate
4	IBEW Union Proposal to City to pay increased employee contribution rate – May 14, 2010
5	SJ POA Union Proposals to City to pay increased employee contribution rate – May 17, 2010 and June 21, 2010
6	IAFF Letter and Proposal to City to pay increased employee contribution rate – June 9, 2010
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11	Association of Engineers and Architects (AEA) – Resolution No. 75451 approving and terms of MOA (7/1/10 – 6/30/11)
12	AEA – Resolution No. 75777 approving and terms of MOA (7/1/11 – 6/30/13)
13	Association of Legal Professionals (ALP) – Resolution No. 75419 approving and terms of Agreement (7/1/10 – 6/30/11)
14	ALP – Resolution No. 75813 approving and terms of Agreement (7/1/11 – 6/30/12)
15	Association of Maintenance Supervisory Personnel (AMSP) – Resolution No. 75452 approving and terms of Agreement (7/1/10 – 6/30/11)

16	AMSP -- Resolution No. 75778 approving and terms of Agreement (7/1/11 -- 6/30/13)
17	City Association of Management Personnel (CAMP) -- Resolution No. 75449 approving and terms of Agreement (7/1/10 -- 6/30/11)
18	CAMP -- Resolution No. 75779 approving and terms of Agreement (7/1/11 -- 6/30/13)
19	Confidential Employees' Organization (CEO), AFSCME Local 101 -- Resolution No. 74635 approving and terms of MOA (9/21/08 -- 9/17/11)
20	CEO -- Resolution No. 75815 approving and terms of Last, Best and Final Offer (9/18/11 -- 9/15/12)
21	International Association of Firefighters (IAFF) -- Resolution No. 75762 approving and terms of Agreement (7/1/09 -- 6/30/13)
22	IAFF -- Resolution No. 75762 approving and terms of Agreement (7/1/09 -- 6/30/13)
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24	IBEW -- Resolution No. 75811 approving and terms of Last, Best and Final Offer (7/1/11 -- 6/30/12)
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32	Executive Management and Professional Employees (Unit 99) and Other Unclassified Non-Management Employees (Units 81 and 82) -- Resolution No. 75363 approving Resolution for 4.75% salary reduction, effective June 27, 2010.

33	Executive Management and Professional Employees (Unit 99) and Other Unclassified Non-Management Employees (Units 81 and 82) – Resolution No. 75436 approving Resolution for 5.4% salary reduction, effective June 27, 2010.
34	Executive Management and Professional Employees (Unit 99) and Other Unclassified Non-Management Employees (Units 81 and 82) – Resolution No. 75780 approving Agreement for 4.75% and 5.4% salary reductions, effective June 26, 2011.
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41	Resolution No. 74803 approving and terms of Agreement between City and SJPOA re Retiree Healthcare Funding
42	Last, Best and Final Offer from City to OE#3 – June 1, 2009
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45	Memorandum from Debra Figone to Mayor and City Council re “Continued Suspension of SRBR Payments” – May 13, 2011
46	Memorandum from Debra Figone to Mayor and City Council re “Suspension of SRBR Payments” – April 9, 2012
47	Letter from Cheiron re “Federated Employees Retirement Plan, Supplemental Retiree Benefit Reserve as of June 30, 2011” - January 13, 2012

48	Letter from Cheiron re "City of San Jose Police and Fire Department Retirement Plan, Supplemental Retiree Benefit Reserve as of June 30, 2011" - March 29, 2012
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50	Tentative Agreement with IBEW re SRBR
51	Tentative Agreement with OE#3 re SRBR
52	Tentative Agreement with CEO re SRBR
53	Tentative Agreement with MEF re SRBR
54	Ordinance No. 29174 amending the Municipal Code to terminate the Federated SRBR and return its funds to the general retirement fund, effective January 4, 2013
55	Ordinance amending the Municipal Code to terminate the Police and Fire SRBR and return its funds to the general retirement fund, enacted on January 29, 2013, and to become effective on March 1, 2013
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**EXHIBIT 1**



Office of the City Auditor

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Report to the City Council  
City of San José

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**PENSION SUSTAINABILITY:  
RISING PENSION COSTS  
THREATEN THE CITY'S  
ABILITY TO MAINTAIN  
SERVICE LEVELS –  
ALTERNATIVES FOR A  
SUSTAINABLE FUTURE**

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Report 10-10  
September 2010

GURZA000001



Office of the City Auditor

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Report to the City Council  
City of San José

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**PENSION SUSTAINABILITY:  
RISING PENSION COSTS  
THREATEN THE CITY'S  
ABILITY TO MAINTAIN  
SERVICE LEVELS –  
ALTERNATIVES FOR A  
SUSTAINABLE FUTURE**

September 29, 2010

Honorable Mayor and Members  
of the City Council  
200 East Santa Clara Street  
San Jose, CA 95113

**Pension Sustainability: Rising Pension Costs Threaten the City's  
Ability to Maintain Service Levels –  
Alternatives for a Sustainable Future**

The City of San Jose provides two defined benefit retirement plans for City employees: the Police and Fire Department Retirement Plan (Police and Fire) for sworn employees, and the Federated City Employees' Retirement System (Federated) for all other benefited City employees. In addition, the City offers a voluntary 457 deferred compensation plan for employees to supplement their savings. City employees do not participate in the Federal Social Security program.

The purpose of this audit was to assess the long-term sustainability of the City's pension benefits and the potential impact of increases in pension costs on City operations, and provide background on pension reform alternatives being pursued by other retirement systems.

This audit focuses on pension benefits. Chapter 1 of the report provides background information about the City's pension benefits. The City also faces considerable challenges with regard its obligations for retiree healthcare.

**Pension benefit increases had dramatic impacts on costs even before recent market losses.** Chapter 2 describes how, over time, the City's two retirement plans have changed significantly. New and enhanced benefits have been added since voters approved minimum benefit levels in 1965. Over the past 20 years, total annual pension benefits paid out of the retirement funds have grown seven fold. The City's annual contributions into the retirement funds to pay for pension benefits doubled from FY 1998-99 to FY 2009-10 and pension contribution rates as a percentage of payroll have grown sharply.

As of June 30, 2009, the City's estimated liability for pension benefits totaled \$5.4 billion. As a result of losses suffered during the 2007-09 economic downturn, the market value of assets as of June 30, 2009 totaled just \$3.4 billion and the City had an estimated unfunded pension liability of \$2 billion based on the market value of assets. Because of the actuarial method of smoothing gains and losses over time, recent market gains and losses have not been fully recognized for actuarial purposes (e.g. the actuarial value of assets as of June 30, 2009 was \$4.3 billion) nor reflected in the actuarially determined



contribution rates to date. In spite of recent strong investment returns (the market value of assets total \$3.8 billion as of June 30, 2010), previous losses are expected to push contribution rates higher as they are recognized in the coming years. Furthermore, the declining ratios of employees to retirees and beneficiaries creates a risk of higher contribution rates. As of June 30, 2009, the City also had a \$1.4 billion unfunded liability for its other post employment benefits (OPEB) based on the market value of assets.

**Rising pension costs threaten the City's ability to maintain service levels.** Chapter 3 addresses the question of sustainability. Personnel costs account for about two-thirds of General Fund expenditures and an increasing portion is attributable to retirement contributions. By FY 2014-15, annual pension and other post-employment benefit (OPEB) contributions are projected to reach 25 percent of total General Fund expenditures, up from 17 percent in FY 2010-11 and 6 percent in fiscal year 2000-01. Recent budget deficits required cuts to services, layoffs, and concessions from employee bargaining groups. Projected future deficits, in part due to rising pension costs, will require similar considerations.

**The City's unfunded pension liability has grown dramatically in recent years.** As of June 30, 2009, the City's unfunded pension liability was \$2 billion on a market value basis. Chapter 4 describes the reasons for the rise in the unfunded liability. One reason, of course, was investment losses totaling about \$978.8 million which were incurred from 2007-2009. In spite of recent investment gains of \$512 million, those losses will continue to affect the City's unfunded liability over the next few years because of the actuarial method of recognizing or smoothing gains and losses.

Another reason for the growth in the unfunded liability was the granting of retroactive benefit enhancements. Because San Jose residents are ultimately responsible for pension costs and retroactive benefit enhancements can create unfunded liabilities, we recommend the City Council explore prohibiting (1) pension benefit enhancements without voter approval and (2) retroactive pension benefit enhancements that create unfunded liabilities.

Another significant reason for the rise in the unfunded liability is that the assumptions used by the plans' actuaries to calculate pension liabilities and contribution rates did not hold true. This resulted in about \$750 million being added to the unfunded liability between June 30, 2007 and June 30, 2009. Actuarial assumptions represent expectations about future events such as investment returns, member mortality and retirement rates, and salary increases, among others. Actuaries use those assumptions to calculate pension liabilities and contribution rates. To ensure the reasonableness of the methods and assumptions used in the plans' actuarial valuations, we recommend the City Council amend the Municipal Code to require an actuarial audit of such valuations every five years if the actuary conducting the valuation has not changed in that time.

**Individual components of the City's pension plans have different impacts on overall costs.** Chapter 5 provides information about the major cost drivers of the City's pension costs. Two major drivers of those costs are the age at which members are eligible to receive benefits (50 for Police and Fire and 55 for Federated) and the plans' guaranteed annual 3 percent cost-of-living adjustment (COLA). Other provisions also have varying impacts on overall cost.

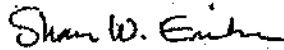
**There are alternatives for a sustainable future.** The City has limited legal maneuverability in how it could change its pension plans for current employees. Nonetheless, it is important that the City move aggressively to rein in pension costs that threaten the stability of the General Fund and the services it provides to the residents of San Jose. It is important to start somewhere, and it is important to start now. Chapter 6 briefly outlines some alternatives and our recommendation that the City Council pursue at least one or a combination of pension cost-containment strategies, including: (1) additional cost sharing by employees, (2) eliminating or at least prohibiting transfers in and distribution of

supplemental benefits when the plans are underfunded, (3) prospective changes in the plans for existing employees, (4) a second tier pension for new hires, and/or (5) joining CalPERS.

**The City will continue to face considerable financial risks from rising pension costs for years to come.** There is a risk that even if the City implements the recommendations in this audit, pension costs may still be unsustainable. Because of the risks of rising pension costs to the City's financial and budgetary future, in Chapter 7 we recommend that the Retirement Services Department (1) provide an annual report to the City Council that includes updates on the financial status of the plans, forecasts of pension costs, and sensitivity analyses showing best and worst case scenarios, and (2) provide an annual summary report to plan members that includes summary financial and actuarial data in an easily accessible format.

I will present this report at the October 21, 2010 meeting of the Public Safety, Finance, and Strategic Support Committee. We are releasing this report well advance of the Committee meeting so that the report can also help inform the work of the General Fund Structural Deficit Elimination Plan Stakeholder Group. The Administration has reviewed the information in this report and their response is shown on the yellow pages.

Respectfully submitted,



Sharon W. Erickson  
City Auditor

finaltr  
SE:bh

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# Glossary

(Glossary items italicized in text of audit)

**Actuarial Assumptions:** Assumptions representing expectations about future events (e.g. expected investment returns on plan assets, member retirement and mortality rates, future salary increases, or inflation) which are used by actuaries to calculate pension liabilities and contribution rates. *Unfunded liabilities* (see below) can grow when actuarial assumptions do not hold true.

**Actuarial Valuation:** Technical reports conducted by actuaries that measure retirement plans' assets and liabilities to determine funding progress. They also measure current costs and contribution requirements to determine how much employers and employees should contribute to maintain appropriate benefit funding progress.

**Actuary:** Professionals who analyze the financial consequences of risk by using mathematics, statistics, and financial theory to study uncertain future events, particularly those of concern to insurance and pension programs. Pension actuaries analyze probabilities related to the demographics of the members in a pension plan (e.g., the likelihood of retirement, disability, and death) and economic factors that may affect the value of benefits or the value of assets held in a pension plan's trust (e.g., investment return rate, inflation rate, rate of salary increases).

**Actuarial Accrued Liability (or Pension Liability):** The value today of all past *normal costs* (see below). Retired employees are no longer accruing benefits, so their actuarial accrued liability is the entire value of their benefit. The liability represents the value of benefits promised to employees and retirees for services already provided. This concept applies to both the pension liability and retiree health care liabilities.

**Annual Required Contribution (ARC):** The amount of money that actuaries calculate the employer needs to contribute to the retirement plan during the current year for benefits to be fully funded over time.

**Experience Gains/Losses:** Gains or losses that arise from the difference between actuarial assumptions about the future and actual outcomes in an organization's pension plan.

**Market Gains/Losses:** Gains or losses that arise from an increase or decrease in the market value of a plan's assets, including stock, real property, and investments.

**Normal Cost:** The portion of the total present value of benefits that actuaries allocate to each year of service. It can be thought of as the annual premium that the employer must contribute to fund the benefit. It is part of the ARC (see above).

**Smoothing of Gains/Losses:** Actuarial method of spreading, or smoothing, market gains and losses over a period of time (five years for both the Police and Fire and Federated plans). The purpose of smoothing is to minimize short-term, year-to-year contribution rate fluctuations which may result from market swings. The smoothed asset value is also known as the actuarial value of assets.

**Unfunded Liability:** This is the unfunded pension obligation for prior service costs, measured as the difference between the accrued liability and plan assets. When using the actuarial value of plan assets, it is also referred to as the Unfunded Actuarial Accrued Liability.

## Chapter I Introduction

In accordance with the City Auditor's 2010-11 Work Plan, we have completed an audit of the sustainability of the City's pension systems. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. We limited our work to those areas specified in the Audit Objective, Scope, and Methodology section of this report.

The City Auditor's Office thanks the Retirement Services Department, the Board members of the Federated City Employees' Retirement System and the Police and Fire Department Retirement Plan, and the Office of Employee Relations for giving their time, information, insight, and cooperation during the audit process.

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### Background

The City of San José (City) provides two retirement plans for City employees: the Police and Fire Department Retirement Plan (Police and Fire) for sworn employees and the Federated City Employees' Retirement System (Federated) for all other benefited City employees.

City employees do not participate in the federal Social Security program. This means that most City employees do not contribute to Social Security or earn quarters towards Social Security benefits while employed by the City of San José. Furthermore, any Social Security benefits they receive as a result of their employment elsewhere may be reduced based on the level of benefit they receive from the City's retirement plans. City employees hired after March 31, 1986 pay mandatory Medicare withholdings.

#### *Other Plans*

Members of the City Council and the Mayor are not members of the City's retirement plans. The City Council and the Mayor are given the option to participate in the California Public Employees Retirement System (CalPERS) or the City's Part-time, Temporary, Contract (PTC) 457 Deferred Compensation Plan. Councilmembers make retirement contributions into CalPERS or the PTC plan through bi-weekly payroll deductions, and the City makes its contributions on a bi-weekly basis.

A few Redevelopment Agency (RDA) staff who are benefited City employees are members of the Federated Retirement System. RDA staff who are not employed by the City participate in a defined contribution 401(a) plan to which the RDA contributes 9 percent of base salary and employees contribute 3 percent of base salary. In addition, the RDA and its employees pay into the Social Security program.



## Pension Sustainability

In accordance with federal regulations, the City also provides a retirement plan (the PTC 457 Deferred Compensation Plan) to its part-time, temporary, and contract employees who do not qualify to be members of the Police and Fire or Federated plans. Participants are required to contribute 3.75 percent of gross earnings which is matched by the City. This plan is in-lieu of Social Security, of which the City is not a participant, as noted previously.

In addition, the City offers a voluntary 457 Deferred Compensation Plan for employees to supplement their retirement savings. As of September 30, 2009, 72 percent of City employees participated in the 457 plan.

### **Pension Formulas and Benefits**

Both Police and Fire and Federated Plans are **defined benefit plans**, meaning that the City provides a stable benefit based on a retiree's years of service with the City and their final compensation.<sup>1</sup> This is in contrast to a **defined contribution plan** such as a 401(k) Plan, whereby retirement benefits are solely determined by the amount of assets that are available in the funds which had been accumulated over time by employer and employee contributions and investment earnings.

The City Charter (Charter) spells out the minimum pension benefits the City provides for employees. The Charter allows the City Council, at its discretion, to grant greater or additional benefits. Sworn employees may also be awarded additional benefits through binding arbitration.<sup>2</sup>

Exhibit I shows the current base pension formulas for the two plans.

**Exhibit I: Current Base Pension Formulas for the City's Retirement Plans**

	<b>Police and Fire</b>	<b>Federated</b>
Eligibility	Age 50 with 25 years of service, 55 with 20 years or any age with 30 years	Age 55 with 5 years of service or any age with 30 years
Benefit Formula	<u>Police members</u> 2.5% of final compensation for each of the first 20 years of service, plus 4% per year of service in excess of 20 years of service <u>Fire members</u> 2.5% of final compensation for each of the first 20 years of service; 3% per year of service if 20 or more years of service	2.5% of final compensation for each year of service
Maximum allowable benefit	90% of final compensation	75% of final compensation

Source: Son José Municipal Code

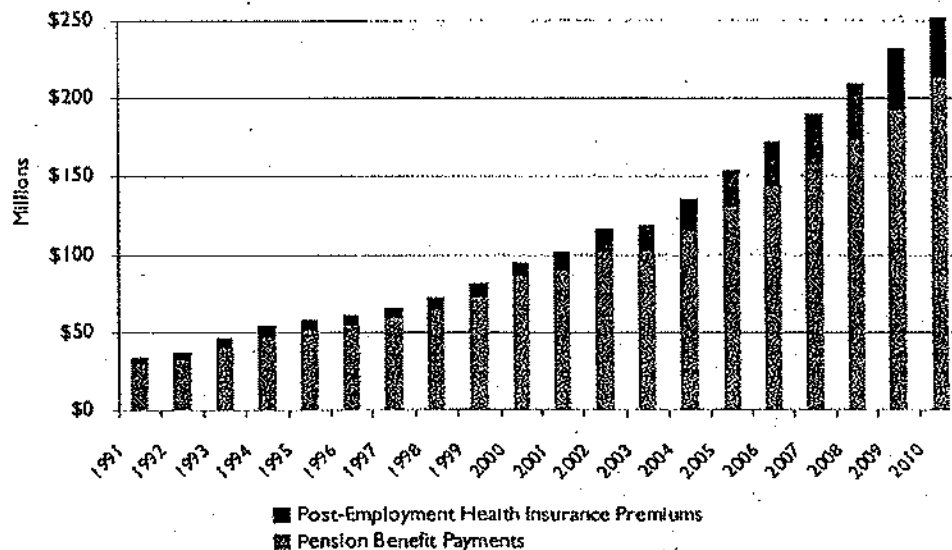
<sup>1</sup> Final compensation is determined as the average base pay of an employee's highest 12 consecutive month period with the City. In general, this does not include overtime or special pay.

<sup>2</sup> The binding interest arbitration process occurs when the City and the police or fire unions are unable to reach an agreement on a successor memorandum of agreement (MOA) during labor contract negotiations and after the impasse resolution procedures have been completed.

In addition to the base pension formulas, other pension benefits include disability and survivor benefits, annual cost-of-living adjustments (COLAs), and supplemental benefits through the plans' Supplemental Retiree Benefit Reserves (SRBR). Besides those pension benefits, the City provides other post-employment benefits (OPEB) such as retiree medical and dental coverage for retirees who meet the minimum service requirements.

Exhibit 2 shows the growth in pension and post-employment benefit payments for both the Police and Fire and Federated Retirement Plans since 1991.

**Exhibit 2: Retirement and Other Post-Employment Benefit Payments for Combined Plans, FY 1990-91 through FY 2009-10**



Source: Comprehensive Annual Financial Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 1990-91 through 2008-09, Draft Fire Department Retirement Plan and Federated City Employees' Retirement System Financial Statements Fiscal Year 2009-10

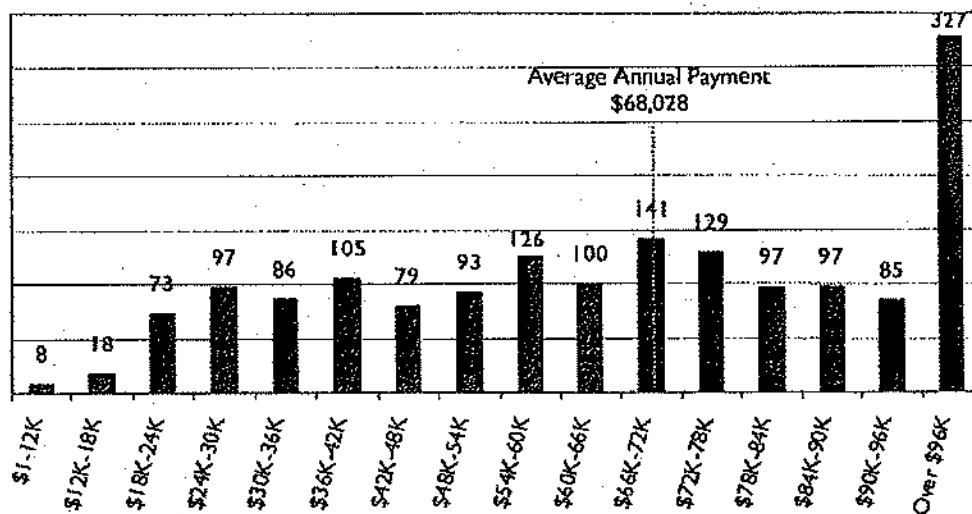
This audit focuses on pension benefits. The City also faces considerable challenges in funding its OPEB benefits. For more information on the City's significant OPEB obligations (including retiree medical and dental coverage) see <http://www.sanjoseca.gov/retireehealthcare/>.

### Pension Payments

As of June 30, 2009, there were 1,661 retirees and other beneficiaries in the Police and Fire plan and 2,997 for the Federated plan.<sup>3</sup> The median retirement age for Police and Fire retirees was 54 years of age and the median length of time they had been receiving retirement benefits was 12 years. The median retirement age for Federated retirees was 56 and they had been receiving retirement benefits on average for 9 years.

As of June 30, 2009 the average annual pension benefit paid to retirees and beneficiaries was about \$68,000 and \$34,500 for Police and Fire and Federated, respectively.<sup>4</sup> Exhibits 3 and 4 provide a stratification of the annual pension benefits paid to retirees and beneficiaries for each plan. As seen in Exhibit 3, there were 327 Police and Fire retirees and beneficiaries (about one-fifth of the total) receiving annual pension benefit payments over \$96,000. Of these, 90 percent retired after 2000.<sup>5</sup>

**Exhibit 3: Annual Pension Payments to Police and Fire Retirees and Beneficiaries as of June 30, 2009**



Note: Does not include OPEB costs. Figures include 201 survivors of active or retired employees, and may include multiple payees per retiree.

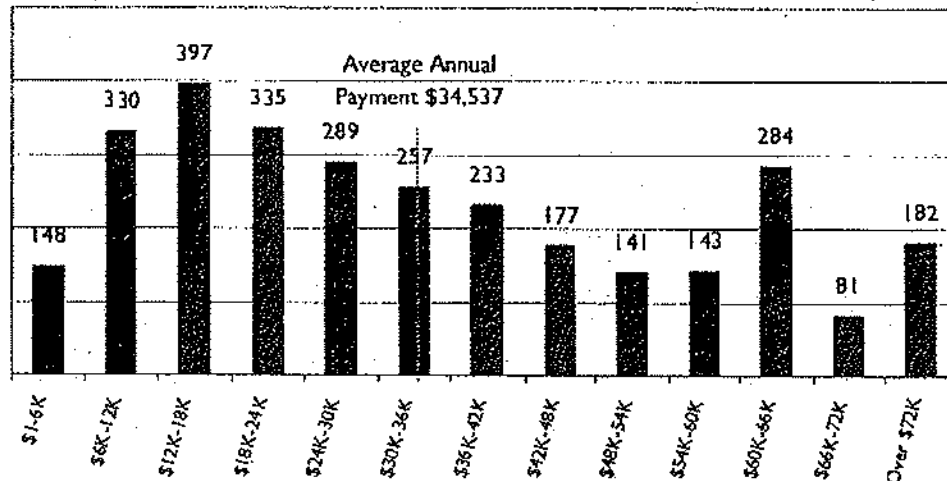
Source: Police and Fire Department Retirement Plan Comprehensive Annual Financial Report for the year ended June 30, 2009

<sup>3</sup> Source: City of San José Comprehensive Annual Financial Report (CAFR) for Fiscal Year Ended June 30, 2009. Copies of the City's and Retirement plans' CAFRs for the fiscal year ended June 30, 2009 are online at <http://www.sanjoseca.gov/auditor/External.asp>. CAFRs for the retirement systems can also be found online at <http://www.sjretirement.com/>.

<sup>4</sup> Actuarial Valuations, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, June 30, 2009.

<sup>5</sup> In 2000, the Police and Fire maximum pension benefit was raised from 80 to 85 percent. It subsequently was raised to 90 percent in later years. These and other benefit enhancements are discussed more fully in Chapter 7.

**Exhibit 4: Annual Pension Payments to Federated Retirees and Beneficiaries as of June 30, 2009**



Note: Does not include OPEB costs. Figures include 419 survivors of active or retired employees, and may include multiple payees per retiree.

Source: Federated City Employees' Retirement System Comprehensive Annual Financial Report for the year ended June 30, 2009

#### Funding of Pensions for the Police and Fire and Federated Plans

Police and Fire and Federated pensions are paid out of retirement funds administered by the Retirement Services Department. Both plans are designed to prefund pension benefits, meaning annual contributions made over the course of an employee's career (by both the City and the employee) along with investment earnings are expected to pay all of the employee's future pension benefits. It is generally assumed that over time, the majority of retirement plan assets will be generated from investment earnings. Even with the large market losses of recent years, investment earnings accounted for more than half of the additions to the retirement funds over the decade ending June 30, 2009.

#### Contributions

The City Charter provides that contributions for retirement benefits allocated to an employee's current year of service are required to be shared by the City with the employee in a ratio that is at least 8:3 ratio (i.e. the City must pay at least eight dollars for every three dollars the employee contributes).<sup>6</sup> This cost is called the *normal* cost of pension benefits.

<sup>6</sup> On the November 2010 ballot there is a measure to amend the City Charter that would, among other things, allow the City Council to provide a retirement plan or plans to new employees that are not subject to the Charter's minimum requirements, including the 8:3 contribution ratio.

## Pension Sustainability

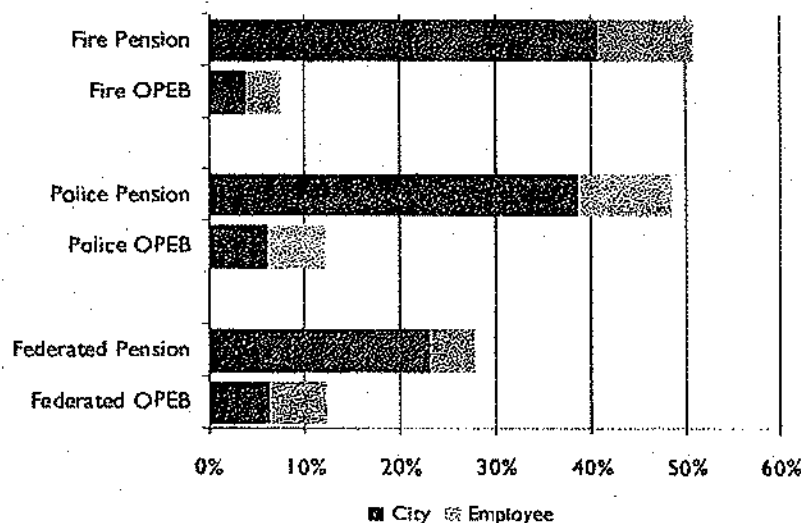
In addition, payment of prior service costs may be necessary because market losses or other circumstances may cause the plans to become underfunded. Under the San José Municipal Code (Municipal Code), 100 percent of the payments to make up for any underfunding have been the responsibility of the City.<sup>7</sup>

Contribution rates are set by the two Retirement Boards based on recommendations by outside *actuaries*. *Actuaries* are contracted by both plans to prepare *actuarial valuations*, the purposes of which are to provide information on the value of the plans' assets and liabilities and to set contribution rates to fully fund plan liabilities.

Funding for OPEB costs is outlined in the San José Municipal Code. The Federated retiree health plan is funded by employer and employee contributions on a 1:1 ratio for medical benefits and an 8:3 ratio for dental benefits. The Police and Fire retiree health plan is funded by employer and employee contributions in a 1:1 ratio for medical benefits and 3:1 ratio for dental benefits.

Contribution rates are set as a percentage of payroll. Exhibit 5 shows the base City and employee contribution rates for FY 2010-11.

**Exhibit 5: City and Employee Contribution Rates for FY 2010-11**



*Note: These rates do not reflect adjustments to the contribution rates as a result of recent negotiations whereby some employee bargaining units agreed to pick up a portion of the City's annual payment to offset the City's contribution rate.*

*Source: Actuarial Valuations, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, June 30, 2009*

<sup>7</sup> As a result of negotiations with bargaining units and Municipal Code amendments related to the City Council's adoption of the FY 2010-11 Budget, some employee bargaining units will pay a portion of their prior service costs to offset the City's costs. This does not reduce the unfunded liability as there will be no additional contributions made (as discussed more fully later).

More information on projected contribution rates is shown in Exhibit 20.

#### Payroll Deductions

Exhibit 6 shows an example of a Federated employee's paycheck and highlights the retirement contribution deductions and how they are broken out between pension costs and retirement health costs. Retirement contributions to the retirement system are mandatory and are deducted biweekly on a pre-tax basis from employee pay. This particular paycheck is from a pay period prior to FY 2010-11 and does not reflect current contribution rates.

**Exhibit 6: Example of a City Employee Paystub**

Hours and Earnings				Taxes			
Description	Hours	Current Earnings	YTD Earnings	Description	Current	YTD	
Regular	80	3,000.00	3,000.00	Fed Withholding	300.00	300.00	
				Fed Med/EE	43.50	43.50	
<b>Total Gross Pay</b>	<b>80</b>	<b>\$ 3,000.00</b>	<b>\$ 3,000.00</b>	<b>Total</b>	<b>\$ 343.50</b>	<b>\$ 343.50</b>	
Employee Tax Deductions				Employer Paid Benefits			
Description	Current	YTD		Description	Current	YTD	
Blue Shield Health	45.91	45.91		Unemployment Insurance	0.27	0.27	
CSJ Vision Plan	6.34	6.34		Blue Shield Health	200.52	200.52	
Retirement Contribution	227.40	227.40		DeltaCare/HMO	25.05	25.05	
				Benefits Administration Fee	4.76	4.76	
				Employee Assistance Program	2.81	2.91	
				Retirement Contribution	858.40	659.40	
<b>Total</b>	<b>\$ 279.65</b>	<b>\$ 279.65</b>		<b>Total</b>	<b>\$ 692.91</b>	<b>\$ 992.91</b>	
<b>Net Pay</b>		<b>\$ 2,720.35</b>					

<b>Employee Portion (7.56%)</b> 4.26% Pension Cost 3.32% Retiree Healthcare Cost <b>City Portion (21.88%)</b> 18.16% Pension Cost 3.82% Retiree Healthcare Cost <b>28.56% Total Retirement Contributions</b>
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Source: Auditor analysis of a random employee pay stub from PeopleSoft

#### Retirement Plan Responsibilities

##### Retirement Boards

Per the San José Municipal Code, the Police and Fire and Federated plans are managed, administered, and controlled by their respective Boards of Administration (Boards). Currently, each seven-member Board is composed of a combination of plan members, retirees, Councilmembers, and Civil Service Commission members. The Police and Fire Board also includes a member of the City Administration and the Federated Board includes a public member. Board members are appointed to four-year terms by the City Council.

## Pension Sustainability

On August 10, 2010, the City Council adopted an ordinance to establish a new plan for Retirement Board Governance that will replace the City Councilmembers and the Civil Service Commission and City Administration members with public members who meet certain experience requirements. The Police and Fire Board was also expanded to nine members by including one additional retiree and one additional public member.

The Boards hold sole fiduciary responsibility over the assets of the plans, including the responsibility of investment of moneys and the administration of the plans. To ensure that the plans remain actuarially sound, the Boards:

- Contract for actuarial investigations and valuations of the plans
- Review and adopt the *actuarial assumptions* used in the valuations (e.g. member mortality, service, and other tables and the assumed rate of return on plan assets)
- Establish contribution rates for the City and employees

It should be noted that the City Administration representative and the retirees and plan members on the Police and Fire and Federated boards are members of the respective plans which they are charged with managing and administering.

### *Retirement Services Department*

The Retirement Services Department's core service is to *Administer Retirement Plans*. Key services include supervising the investment of plan assets; administering retirement benefits; and analyzing, developing and recommending policy for the Boards. The Department's operating budget for FY 2010-11 is \$4.4 million with 33.5 authorized full-time equivalent staff. Retirement Services employees are members of the Federated City Employees' Retirement System.

### *City Manager's Office of Employee Relations*

The Office of Employee Relations (OER) is responsible for negotiating on behalf of the City with representatives of the eleven bargaining units representing City employees regarding wages, hours, and other terms and conditions of employment, including retirement benefits. OER employees are members of the Federated City Employees' Retirement System.

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## **Audit Objective, Scope, and Methodology**

The objectives of our audit were to assess the long-term sustainability of the City's pension benefits and the potential impact of increases in pension costs on City operations, and provide background on pension reform alternatives.

To achieve our audit objectives we performed the following:

1. To obtain a history of the City's retirement plans we obtained and reviewed the following documents for each plan:

- *Actuarial valuation* reports, experience studies, annual reports, and/or comprehensive annual financial reports for the years 1981 through 2009
- Memoranda from Retirement Services staff, outside actuaries, and investment professionals to the Retirement Boards about *actuarial assumptions* and methods, investments, and other relevant subjects
- City Council and staff memoranda related to pension costs and budget considerations
- Retirement Board minutes surrounding discussions of *actuarial assumptions* and methods

We also reviewed the City's 2000-01 through 2009-10 Operating Budgets, draft Police & Fire and Federated Retirement Plan Financial Statements for 2009-10, the City Manager's 2011-15 Five-Year Economic Forecast and Revenue Projections, the City Charter, the Municipal Code, Memoranda of Agreement with employee bargaining groups, and relevant pension laws and regulations.

In addition, we interviewed staff from the Retirement Services Department, the City Manager's Budget Office, the Office of Employee Relations, and members of both the Federated and Police and Fire Retirement Boards.

2. To evaluate the *actuarial assumptions* and methods used by the two plans, we reviewed the City's retirement plans' current and historical *actuarial assumptions* and methodologies. We also reviewed *Actuarial Standards of Practice* and other documents to obtain an understanding of the actuary's role in preparing valuations and recommendations on plan assumptions and contribution rates.
3. To review other public retirement systems and alternative pension reform options, we evaluated *actuarial valuation* reports, comprehensive annual financial reports, and other information related to other public retirement plans, such as the California Public Employees' Retirement System (CalPERS), federal employee retirement plans, plans for other California local governments, and plans outside of California.

We also reviewed *Developing a Policy for Retirement Plan Design Options* (1999, 2007), *Essential Design Elements of Defined Benefit Retirement Plans* (2008), and *Sustainable Funding Practices of Defined Benefit Pension Plans* (1994, 2005, 2008 and 2009) published by the Government Finance Officers Association.

At our request, to determine the major cost drivers of the City's retirement plans, Retirement Services staff assessed the costs of various components of the City's pension plans as a proportion of the overall system costs.



4. To assess the accuracy and reliability of pension data, we examined a sample of retirees from the Federated and Police and Fire Retirement Systems and reconciled retiree pension information to actuarial data files, the PensionGold pension administration system, and, where applicable, PeopleSoft.<sup>8</sup>

In addition, to obtain an understanding of the overall current pension environment we reviewed various reports and documents related to public and private pension systems and other pension-related literature. Further, we reviewed the Governmental Accounting Standards Board (GASB) Proposed Changes to Accounting Rules Under Statements 25, 27, 43 and 45, titled *Postemployment Benefit Accounting and Financial Reporting*. We should note that as City employees, the Auditor's Office staff are members of the Federated City Employees' Retirement System.<sup>9</sup>

#### **Previous Audit of Pensionable Earnings and Time Reporting**

During FY 2009-10 we conducted an Audit of Pensionable Earnings and Time Reporting, which identified payroll and retirement errors resulting in higher pension to retirees, unclear and duplicative time reporting codes, and retirees benefiting from the City's definitions of highest year and earnable income. The report included 15 recommendations that were accepted by the City Council and are in the process of being implemented. This included recommendations to correct the errors that resulted in higher pensions, and recommendations to consider amending the Municipal Code to (1) calculate final compensation as the highest base salary received (rather than base salary earnable), (2) credit one year of federated city service for 2,080 hours of service rendered in a calendar year (rather than 1,739 hours), and (3) return to using a three year average in calculating pension benefits (rather than the highest salary received in any twelve month period). The City will be in negotiations with the majority of bargaining groups in 2011 and will be considering these issues as part of the retirement reform discussions.<sup>10</sup>

#### **Additional information**

Additional information about the City's retirement benefits can be found on the Retirement Services website at <http://www.siretirement.com/> and the OER website at <http://www.sanjoseca.gov/employeeRelations/RetirementBenefits.asp>.

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<sup>8</sup> We reviewed a random sample of four Federated retirees from a population of 2,578 Federated retirees; and a sample of six Police and Fire retirees from a population of 1,455 Police and Fire retirees.

<sup>9</sup> Government Auditing Standards state that auditors are not precluded from auditing pension plans that they participate in if (1) the auditor has no control over the investment strategy, benefits, or other management issues associated with the pension plan and (2) the auditor belongs to such pension plan as part of his/her employment with the audit organization, provided that the plan is normally offered to all employees in equivalent employment positions.

<sup>10</sup> The report is online at [www.sanjoseca.gov/auditor](http://www.sanjoseca.gov/auditor).

## **Chapter 2 Pension Benefit Increases Had Dramatic Impacts on Costs Even Before Recent Market Losses**

### **SUMMARY**

Over time, the City's two retirement plans have changed significantly. New and enhanced benefits have been added since voters approved minimum benefit levels in 1965. As a result of plan changes, current pensions are higher than what employees would have received under previous benefit levels. Over the past 20 years, total annual pension benefit payments to retiree and beneficiaries have grown seven fold, in part because the average benefit has grown and in part because the beneficiary population is two and a half times larger than it was in FY 1990-91. The City's annual contributions into the retirement funds to pay future pension benefits doubled from FY 1998-99 to FY 2009-10, and contribution rates (expressed as a percentage of payroll and inclusive of contributions for OPEB costs) have grown sharply in recent years. They are projected to reach more than 75 percent of payroll for Police and Fire and 45 percent for Federated by FY 2014-15.

As of June 30, 2009, the City's pension liabilities totaled \$5.4 billion, compared to \$2.1 billion ten years earlier. This liability represents the amount promised to employees and retirees for pension benefits for services already provided. By comparison, as a result of losses suffered during the recent economic downturn, the market value of assets totaled just \$3.4 billion. As of June 30, 2009, the City had a \$2 billion unfunded pension liability based on that market value. Because of the actuarial method of *smoothing* gains and losses over time, the actuarial value of assets totaled \$4.3 billion; the effect of this is that the impact of recent market gains and losses have not been fully reflected in the City's retirement contribution rates. As of June 30, 2009, the City also had a \$1.4 billion unfunded liability for retiree healthcare based on the market value of assets. Furthermore, the declining ratio of employees to retirees and beneficiaries creates a risk of higher contribution rates in the future. At current contribution rates, estimates show that the amount owed in pension liabilities will continue to grow at a much faster rate than available plan assets.

**New and Enhanced Benefits Have Been Granted Since the Voters Approved Benefit Minimum Levels in 1965**

The City has provided pension benefits to its employees for decades. The Charter spells out the minimum benefits the City's two retirement plans must provide for members. According to the City Attorney's Office, the current minimum benefits were approved by San José voters in 1965. The Charter minimum benefit for Police and Fire members is 50% of final compensation at age 55 upon completion of 20 years of service, final compensation defined as average compensation in the final three years of service. The Charter minimum benefit for Federated members is 2% of final compensation per year of service for first 25 years of service plus 1% for each year beyond 25 at age 55 subject to an 85% maximum; or at age 70 regardless of years of service.<sup>11</sup>

The City Council has the authority to grant benefits greater than the minimum benefits spelled out in the City Charter, and has granted benefit enhancements pursuant to negotiations with employee bargaining groups. Police and Fire members may also be awarded benefits through binding interest arbitration. Recent plan changes have been modified to provide benefits similar to those made by other California local governments, which followed benefit enhancements awarded at the state level during the dot-com boom.

Both retirement plans have changed over time, in some ways significantly. Since 1965, the formula for calculating Police and Fire pensions has changed more than five times and for Federated twice. Police and Fire had a retirement age of 55, but now members can retire at 50. The Municipal Code has been amended to modify the computation of final average compensation from a three-year average to the highest average of 12 consecutive months for both plans. In addition, the Municipal Code has been amended to provide survivorship benefits, a guaranteed 3 percent COLA, and the establishment of the Supplemental Retiree Benefit Reserves (SRBR) have also been granted to both retirement plans.

Following are selected changes to each plan over time for service retirements.<sup>12</sup>

Police and Fire (current plan established 1961)

1961 Retirement age was 55 with 20 years of service or age 65 regardless of years of service. Benefit was 50% of final compensation. Final compensation was defined as highest average during three consecutive years of service.

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<sup>11</sup> On the November 2010 ballot there is a measure to amend the City Charter that would, among other things, allow the City Council to provide a retirement plan or plans to new employees that are not subject to the Charter's minimum requirements, including the 8:3 contribution ratio.

<sup>12</sup> Not all retirement changes or benefit enhancements are included in the histories listed.

- 1968 Retirement age reduced from 55 with at least 20 years of service to 50 or older with at least 20 years of service or at any age with 30 years of service. Benefit formula increased for members who were at least 55 at time of retirement increased to 50% of final compensation plus 1.66% per year of service in excess of 20; maximum benefit set at 66.66% of final compensation. For members who retired before age 55, benefit stayed at 50% of final compensation.
- 1970 Benefit formula changed for members who were at least 55 at time of retirement or had 30 years of service to 50% of final compensation plus 2.5% of final compensation per year of service in excess of 20; maximum benefit raised to 75% of final compensation. Definition of final compensation changed to highest one year, not to exceed 108% of the 12 months preceding final 12 months of service. COLA introduced at CPI not exceed 3%.
- 1984 City Council grants medical benefits to members of the Police and Fire Plan.
- 1986 City Council adds dental benefits to the Police and Fire Plan.
- 1994 Reciprocity with CalPERS established (which potentially can affect the years of service<sup>13</sup> and final compensation determinations)
- 1998 Benefit formula changed (retroactive to February 1996 for members who were at least 55 at time of retirement or had 30 years of service) to 2.5% of final compensation for each of first 20 years of service, plus 3% per year of service in excess of 20; maximum benefit raised from 75% to 80% of final compensation as awarded through binding interest arbitration.
- 2000 Benefit formula changed for members who were at least 55 at time of retirement or had 30 years of service to 4% of final compensation for years in excess of 25. Maximum benefit raised from 80% to 85% of final compensation.
- 2002 COLA changed to a guaranteed 3% annual adjustment. Police and Fire Supplemental Retiree Benefit Reserve (SRBR) established in 2001, commenced distributions. SRBR provides up to one additional pension payment per year in an amount that depends on investment earnings, compensation, years of service, and time retired.
- 2006 Benefit formula for Police members who were at least 55 at time of retirement or had 30 years of service changed to 2.5% of final compensation per year of service for first 20 years plus 4% of final compensation per year beyond 20; maximum benefit for Police members raised to 90% of final compensation.
- 2008 Benefit formula for Fire members who were at least 55 at time of service or had 30 years of service changed to 2.5% of final compensation per year of service for up to 20 years; if 20 or more years of service, 3% of final compensation; maximum benefit for Fire members raised to 90% of final salary as awarded through binding interest arbitration.

<sup>13</sup> Reciprocity can affect the years of service for the purpose of establishing entitlement to a pension, but does not affect the years of service for the pension benefit calculation or entitlement to health benefits.

Federated (current plan established 1975)

- 1975 Retirement at age 55 or older with 5 years of service or any age with 30 years of service. Benefit formula set at 2.5% of final compensation for each year of service (previously set at 2% for each year of service for first 20 years with additional 1.0 to 1.3% for additional years), subject to a maximum benefit of 75% of final compensation. Final compensation defined as highest annual average earnable during any 3 years consecutive years of service. COLA set at CPI not to exceed 3%.
- 1984 City Council grants medical benefits to members of the Federated Plan.
- 1986 Federated SRBR established. SRBR provides up to one additional pension payment per year in an amount that depends on investment earnings, compensation years of service and time retired. City Council adds dental benefits to the Federated Plan.
- 1994 Reciprocity with CalPERS established. (same impact as noted earlier)
- 2001 Final compensation defined as average compensation earnable for highest consecutive 12 months.
- 2006 COLA changed to a guaranteed 3% annual adjustment.

**As a Result of Plan Changes, Current Pensions Are Higher Than What Employees Would Have Received Under Previous Benefit Levels**

To illustrate the impact of formula changes on calculated benefits, we drew a sample of retirees and compared their actual base pension to benefit levels calculated using past pension formulas. Exhibit 7 shows a sample of Police and Fire retirees' actual base pension benefit and a comparison with calculated benefits under previous pension formulas.

All sample retirees included in Exhibit 7 started service with the City after 1970 and retired after January 1, 2005.<sup>14</sup> The maximum retirement benefit allowed at the time each commenced service with the City was 75 percent of final average compensation. On average, the Police and Fire retirees in our sample are receiving about 8 percent more than the formula in place when they started City service (or about \$11,000 on average), not including cost of living adjustments or SRBR distributions.

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<sup>14</sup> We selected a random sample of six Police and Fire retirees from a population of 1,455 Police and Fire retirees.

For example, employee #3 retired in 2007 with a current annual pension of \$125,752, or nearly \$15,000 more than their pension would have been under the formula in place when he or she began employment. If the retiree receives a pension for 20 years, total benefits paid out of the retirement fund (including the guaranteed annual COLA, but not including any SRBR distributions) will be nearly \$500,000 more than if the benefit formula had not been enhanced over time.

**Exhibit 7: Impact of Pension Benefit Formula Changes on a Sample of Police and Fire Retirees**

Sample Retiree	Base Pension Amount
#1 (Fire) Retirement date: 1/27/07 Years of service: 25.4 Final compensation: \$146,340	(1) Calculated under pre-1996 formula: \$92,925 (2) Calculated under 1996-2000 formula: \$96,877 (3) Actual base pension: \$97,503 Difference: \$4,578 per year
#2 (Fire) Retirement date: 1/29/05 Years of service: 32.3 Final compensation: \$172,704	(1) Calculated under pre-1996 formula: \$129,528 (2) Calculated under 1996-2000 formula: \$138,163 (3) Actual base pension: \$146,799 Difference: \$17,271 per year
#3 (Fire) Retirement date: 7/3/07 Years of service: 32.4 Final compensation: \$147,948	(1) Calculated under pre-1996 formula: \$110,958 (2) Calculated under 1996-2000 formula: \$118,355 (3) Actual base pension: \$125,752 Difference: \$14,794 per year
#4 (Fire) Retirement date: 6/27/09 Years of service: 28.0 Final compensation: \$173,016	(1) Calculated under pre-1996 formula: \$121,242 (2) Calculated under 1996-2000 formula: \$128,189 (3) Calculated under 2000-2008 formula: \$133,431 (4) Actual base pension: \$145,491 Difference: \$24,249 per year
#5 (Police) Retirement date: 6/18/05 Years of service: 27.3 Final compensation: \$110,796	(1) Calculated under pre-1996 formula: \$75,675 (2) Calculated under 1996-2000 formula: \$79,731 (3) Actual base pension: \$82,303 Difference: \$6,628 per year
#6 (Police) Retirement date: 1/28/06 Years of service: 20.1 Final compensation: \$111,444	(1) Calculated under pre-1996 formula: \$55,882 (2) Calculated under 1996-2000 formula: \$55,914 (3) Actual base pension: \$55,914 Difference: \$32 per year

Source: Auditor analysis based on information obtained from Pension Gold, San José City Charter and Municipal Code

Notes to accompany Exhibit 7 (calculations for illustrative purposes only; do not include COLA or SRBR):

- All pensions are stated as actual base in first year of retirement.
- Pre-1996 pension formula calculated as 2.5% per year of service, maximum = 75% of final compensation
- 1996-2000 pension formula was 2.5% per year of service for first 20 years of service, 3% per year over 20, maximum of 80% of final compensation
- 2000-2006 (Police) and 2000-2008 (Fire) pension formula was 2.5% per year of service for first 20 years, 3% for next 5, 4% over 25; maximum of 85% of final compensation
- 2006-Current Police formula is 2.5% per year of service for first 20 years, and 4% for each year thereafter; maximum is 90% of final compensation
- 2008-Current Fire formula is 2.5% per year if less than 20 years of service; if more than 20 years of service, 3% per year; maximum is 90% of final compensation

## Pension Sustainability

As shown in Exhibit 8, we conducted a similar analysis for a sample of Federated retirees.<sup>15</sup> For the employees in our sample, current pension benefits are about 11 percent higher than they would have been calculated under the formula that was in effect prior to the most recent change. For example, sample employee #1 retired in 2008 with a current annual pension of \$116,070 compared to an estimated \$104,579 benefit under the formula in place prior to 1975.

**Exhibit 8: Impact of Pension Benefit Formula Changes on a Sample of Federated Retirees**

Sample Retiree	Base Pension Amount
<b>Retiree #1</b> Retirement date: 6/28/08 Years of service: 24.1 Final compensation: \$192,861	(1) Calculated under 1975 formula: \$104,579 (2) Actual base pension: \$116,070 Difference: \$11,491 per year
<b>Retiree #2</b> Retirement date: 3/10/07 Years of service: 21.3 Final compensation: \$47,227	(1) Calculated under 1975 formula: \$22,634 (2) Actual base pension: \$25,174 Difference: \$2,540 per year
<b>Retiree #3</b> Retirement date: 7/3/04 Years of service: 15.4 Final compensation: \$62,185	(1) Calculated under 1975 formula: \$21,547 (2) Actual base pension: \$23,903 Difference: \$2,356 per year
<b>Retiree #4</b> Retirement date: 1/6/01 Years of service: 27.5 Final compensation: \$43,659	(1) Calculated under 1975 formula: \$27,014 (2) Actual base pension: \$29,970 Difference: \$2,956 per year

Source: Auditor analysis based on information obtained from Pension Gold, PeopleSoft, San José City Charter and Municipal Code

Notes to accompany Exhibit 8 (calculations for illustration purposes only; do not include COLA or SRRB):

- 1975 pension formula was 2.5% per year of service, maximum benefit 75% of final compensation (highest year average). Calculation assumes highest three year average is 90% of highest one year average compensation.
- Current pension formula is 2.5% per year of service, maximum benefit is 75% of final compensation; final compensation is highest one year average.

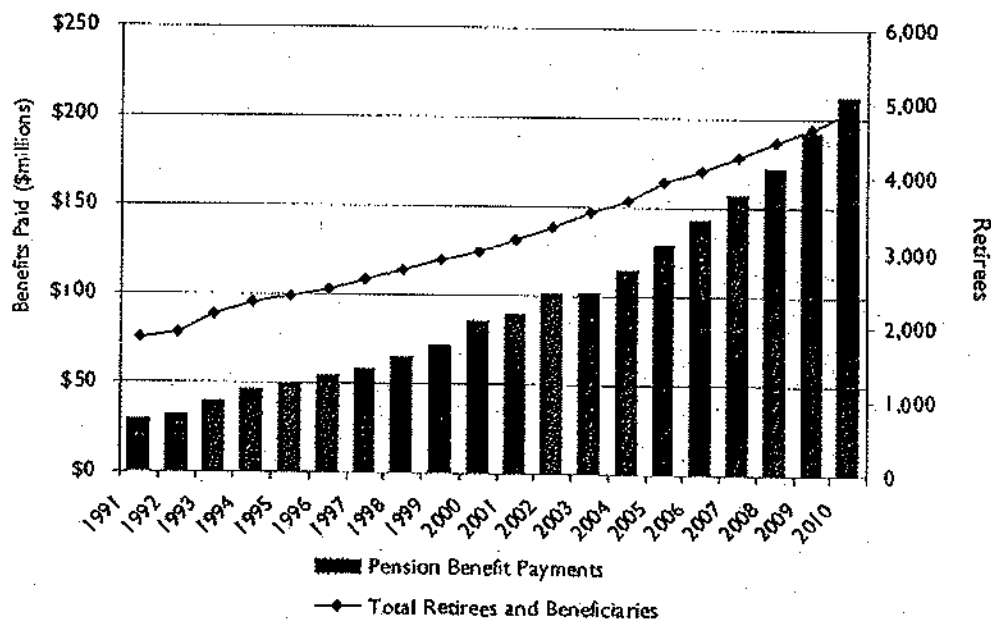
## **Pension Benefit Payments to Retirees and Beneficiaries Have Grown Seven Fold Over the Past Twenty Years**

Over the past 20 years total pension benefits paid out of the retirement funds have grown seven fold, in part because the average annual pension benefit increased by about 175 percent for Police and Fire and 150 percent for Federated, and in part because the number of beneficiaries is two and a half times larger than it was in FY 1990-91.

<sup>15</sup> We selected a sample of four Federated retirees on a random basis from a population of 2,578 Federated retirees.

Exhibit 9 shows the growth in pension benefits paid out of the City's retirement funds and the growth in the total retiree and beneficiary population from FY 1990-91 through FY 2009-10. In FY 2009-10, the retirement plans paid out more than \$210 million in pension benefits, compared to \$72 million in FY 1998-99 and \$30 million in FY 1990-91.<sup>16</sup> Over that same time, the number of retirees and beneficiaries grew from 1,816 to 4,891. These trends are likely to continue into the future as about 30 percent of the City's workforce was within five years of retirement eligibility as of October 2009.

**Exhibit 9: Growth in Pension Benefit Payments and Total Retirees and Beneficiaries, FY 1990-91 Through FY 2009-10**



Sources: Comprehensive Annual Financial Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 1990-91 through 2008-09, Draft Police and Fire Department Retirement Plan and Federated City Employees' Retirement System Financial Statements Fiscal Year 2009-10

#### Growth in Average Annual Pension Benefit Paid

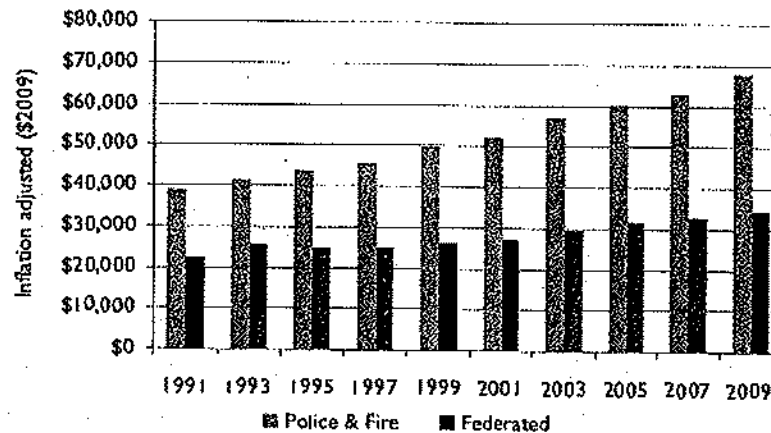
Exhibit 10 shows the growth in the average annual pension benefit paid to retirees and beneficiaries from FY 1990-91 through FY 2008-09 for both plans (adjusted for inflation). The increase in the average annual pension benefit paid is partly due to a rise in average salaries. Over this same period, average salaries increased by 135 percent for Police and Fire members and 106 percent for

<sup>16</sup> These figures are unadjusted for inflation and do not include payments for other post-employment benefits such as the cost for retiree health and dental benefits. In FY 2008-09, the Retirement Plans paid nearly \$40 million for post-employment health insurance premiums.



Federated members. Even after adjusting for inflation, the average annual pension benefit has increased over this period by about 75 percent for Police and Fire and 54 percent for Federated.

**Exhibit 10: Growth in the Average Annual Pension Benefit Paid Adjusted for Inflation (2009 dollars)**



Sources: Actuarial Valuations and Annual Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 1990-91 through 2008-09; U.S. Department of Labor, Bureau of Labor Statistics

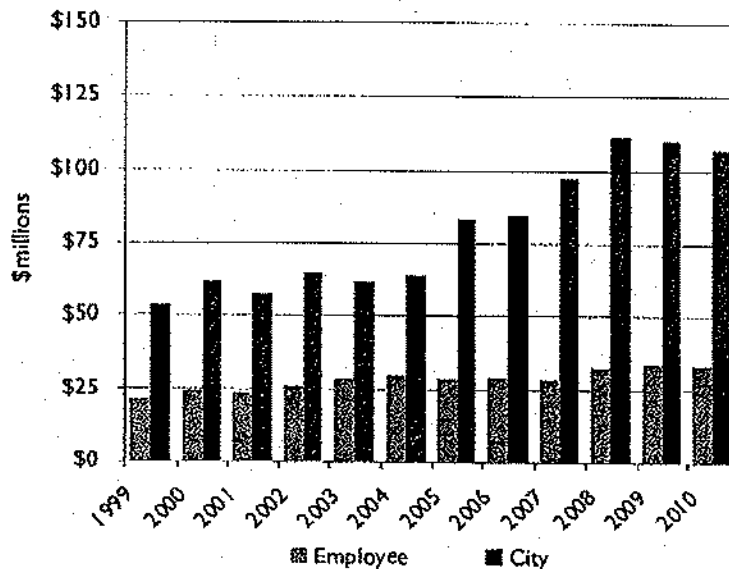
Note: Averages calculated based on number of retirees and beneficiaries. This includes survivors of active or retired employees, and may include multiple payees per retiree.

### **The City's Annual Contributions Into the Retirement Funds Doubled Over the Past Decade**

The City has had to make increasingly larger annual contributions to its retirement plans to ensure there are enough assets to pay for future pension benefits. From FY 1998-99 to FY 2009-10, the City's annual contributions into the retirement funds doubled from about \$54 million to about \$107 million.

Exhibit 11 shows the total annual contributions to the retirement plans by both the City and employees from FY 1998-99 through FY 2009-10. Note that although total employee contributions have increased (from about \$21 million in FY 1998-99 to about \$33 million in FY 2009-10), they have not increased at nearly the same rate as the City's contributions.

**Exhibit 11: Annual Contributions for Pension Benefits Doubled Between FY 1998-99 Through FY 2009-10**



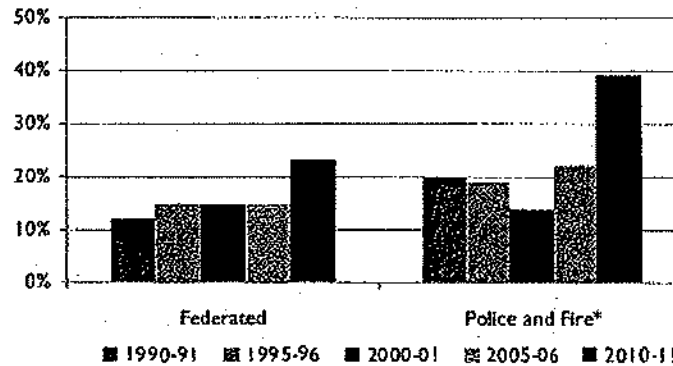
Sources: Comprehensive Annual Financial Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 1998-99 through 2008-09, Draft Police and Fire Department Retirement Plan and Federated City Employees' Retirement System Financial Statements Fiscal Year 2009-10

Divided by the number of active employees shown in the retirement plans' Comprehensive Annual Financial Reports, the City's contributions per employee rose from about \$11,600 to about \$24,800 for Police and Fire (about 212 percent) and from about \$7,200 to about \$12,000 for Federated (about 165 percent) from FY 1998-99 through FY 2009-10.

**The City's Contribution Rates Have Risen Sharply in Recent Years and Are Projected to Rise Even Further in the Near Future**

Over the past 10 years, the City has experienced a profound increase in the percent of payroll that it pays to the retirement plans for future pension benefits. The City's contribution rates (expressed as a percent of payroll) have more than doubled since FY 1990-91, including significant growth in the last five years. Exhibit 12 shows the City's contribution rates at five-year intervals since FY 1990-91.

**Exhibit 12: The City's Retirement Contribution Rates as a Percent of Payroll, FY 1990-91 Through FY 2010-11<sup>17</sup>**



\*Actual rate in FY 2010-11 for police members is 38%. For fire members, it is 40%  
 Sources: Retirement Plan Comprehensive Annual Financial Reports and Annual Reports, Fiscal Years 1990-91 through 2008-09

**Projected Rate Increases Outstrip Anything Seen to Date**

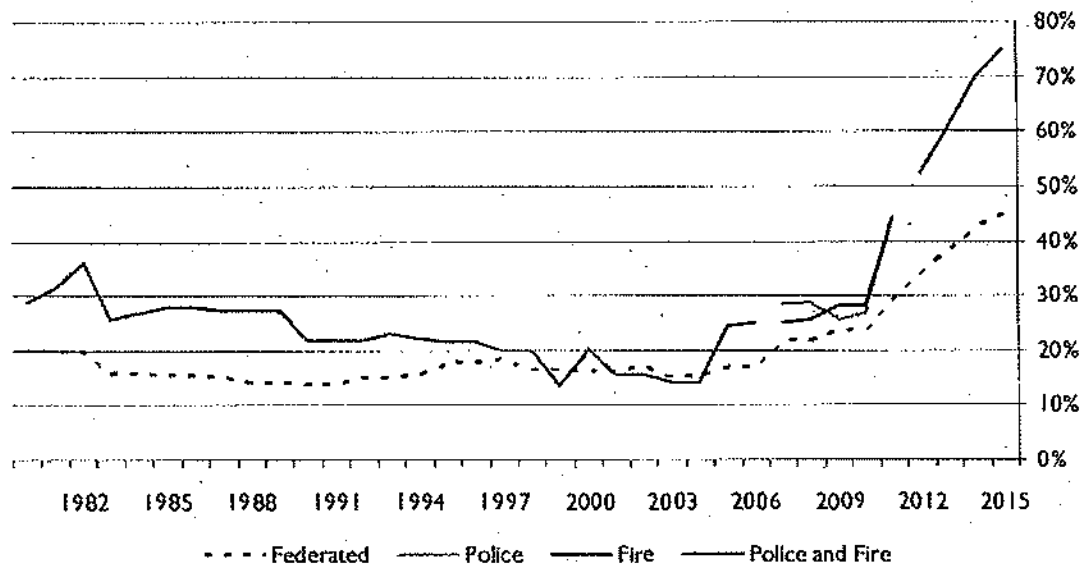
Exhibit 13 shows the change in contribution rates from FY 1980-81 to projected rates through FY 2014-15, inclusive of rates for retiree medical and dental benefits. Contribution rates for Police and Fire declined steadily from the early 1980's through about 2003 before rising rapidly to today's high rates. For Federated, rates remained below 20 percent for many years before recent increases.

According to the City Manager's Office's *Five-Year Economic Forecast and Revenue Projections for the General Fund and Capital Improvement Program*<sup>18</sup> future rates are expected to rise to around 75 percent of payroll for Police and Fire and more than 45 percent for Federated, causing the projected annual retirement contribution paid out of the City's General Fund to be more than \$270 million in FY 2014-15. This is more than the entire FY 2010-11 Operating Budgets for the Fire Department, the Airport, and the City's libraries combined.

<sup>17</sup> These figures do not reflect adjustments to the City's rates as a result of recent negotiations whereby some employee bargaining units agreed to pick up a portion of the City's annual payment to offset the City's contribution rate.

<sup>18</sup> The forecast is online at see <http://www.sanjoseca.gov/budget/FY1011/FiveYearForecast.asp>

**Exhibit 13: The City's Retirement Contribution Rates for Pension and Retiree Health Benefits, FY 1980-81 Through FY 2014-15 (projected)**



Sources: Comprehensive Annual Financial Reports and Annual Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 1980-81 through 2008-09, Retirement Board May 2010 Rate Resolutions, and the City Manager's Budget Office

More detail on the City's projected contribution rates going forward (and the breakdown between pension and OPEB contributions) is shown in Exhibit 20.

### **The Retirement Plans' Unfunded Liabilities Play a Major Role in Rising Contribution Rates**

#### **As of June 30, 2009, A \$5.4 Billion Pension Liability...**

As the number of retirees has increased and as the City has enhanced benefits, the City's pension liability (that is, the amount of benefits promised to current employees and retirees) has grown dramatically. As of June 30, 2009, the City's estimated liability for pension benefits already earned was \$5.4 billion – or, put another way, the City had an estimated \$5.4 billion in pension liabilities. This compares to \$2.1 billion in pension liabilities ten years earlier.

#### **...But Only \$3.4 Billion in Pension Assets**

As a result of the 2007-09 economic downturn, the combined investment losses in the two plans for the fiscal years 2007-08 and 2008-09 totaled \$978.8 million. As of June 30, 2009, the market value of the plans' assets was \$3.4 billion, or \$2 billion less than the combined pension liabilities.

It is important to note that as of June 30, 2009, the actuarial value of the combined plan assets totaled \$4.3 billion, or about \$1 billion more than the market value of the plans' assets. This is because, for actuarial purposes, market gains and losses are not fully recognized by the plans in the year they occur. They are recognized (or smoothed) over five years to minimize the impact of market volatility on annual contribution rates. The effect of this is that the large market losses suffered in fiscal years 2007-08 and 2008-09 have not yet been fully recognized for actuarial purposes.

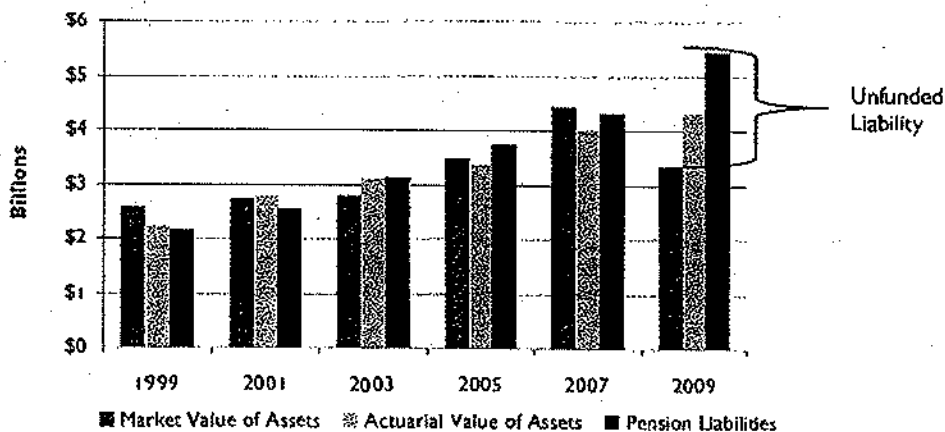
It is also important to note that during fiscal year 2009-10, the combined investment gains for the two plans totaled \$512 million.<sup>19</sup> As of June 30, 2010, the market value of the plans' assets was \$3.8 billion. Nonetheless, as investment gains and losses are recognized over the next few years, it is expected that the City's contribution rates will rise.

**As of June 30, 2009, the City Had a \$2-Billion Unfunded Pension Liability**

The difference between the pension liability and the value of plan assets is called the *unfunded liability*. The *unfunded liability* is calculated two ways: (1) based on the market value of assets, and (2) based on the actuarial value of assets. Using the market value of assets, the City's combined *unfunded liability* for both pension plans totaled \$2 billion as of June 30, 2009. As described earlier, using the actuarial (or smoothed) value of assets, the City's unfunded pension liability is less – \$1.1 billion.

Exhibit 14 shows the market and actuarial values of the combined plan assets compared to pension liabilities from FY 1998-99 through FY 2008-09.

**Exhibit 14: Market and Actuarial Values of Plan Assets Compared to Pension Liabilities, FY 1998-99 Through FY 2008-09**



Source: Auditor analysis of retirement plan actuarial valuations, 1999 through 2009

<sup>19</sup> Includes \$314 million for Police and Fire, and \$198 million for Federated.

### As of June 30, 2009, the City Also Had a \$1.4 Billion Unfunded Retiree Healthcare Liability

The City also has an estimated \$1.4 billion in unfunded liabilities as a result of promised OPEB benefits. In addition to pension benefits, the City sponsors and administers the Federated and Police and Fire post-employment healthcare plans. As of the June 30, 2009 actuarial valuation dates, the estimated accrued liability for Police and Fire retiree healthcare (i.e. OPEB) benefits was about \$762 million, of which about \$719 million was unfunded; and the estimated liability for Federated OPEB benefits was about \$796 million, of which about \$711 million was unfunded.

In previous years, the City only partially pre-funded OPEB costs based on 10 or 15 year cash flow projections for the retirement plans. For FY 2009-10, the policy was changed to fully prefund the annual required contribution of OPEB costs after a five-year phase-in period for the majority of its employee units (with the exception of Fire Department plan members). The unfunded liability is being amortized, or paid down, over 30 years. This "pay down" is included as part of the annual contribution and will result in increases in contributions for the City and employees.

More information about the City's retiree healthcare funding status can be found at <http://www.sanjoseca.gov/retireehealthcare/>.

### Funded Ratios Have Fallen

The ratio of plan assets to plan liabilities determines the plan's funded ratio. If plan assets are greater than liabilities, then the funded ratio will be over 100 percent. Alternatively, if plan liabilities exceed plan assets, the funded ratio will be less than 100 percent. Many experts, including the Government Finance Officers' Association, consider a funded ratio of about 80 percent of market value or better to be sound for government pensions.

Comparing the market value of plan assets to the estimated pension liability, Police and Fire was 66 percent funded, and Federated was 55 percent funded as of June 30, 2009. Exhibit 15 shows both plans' funded status for pension benefits using both the actuarial (or smoothed) value and the market value of plan assets. Exhibit 15 illustrates the effect that *smoothing* has on the actuarial value of assets, in this case by deferring the impact of market losses.

**Exhibit 15: Pension Funded Ratios, June 30, 2009**

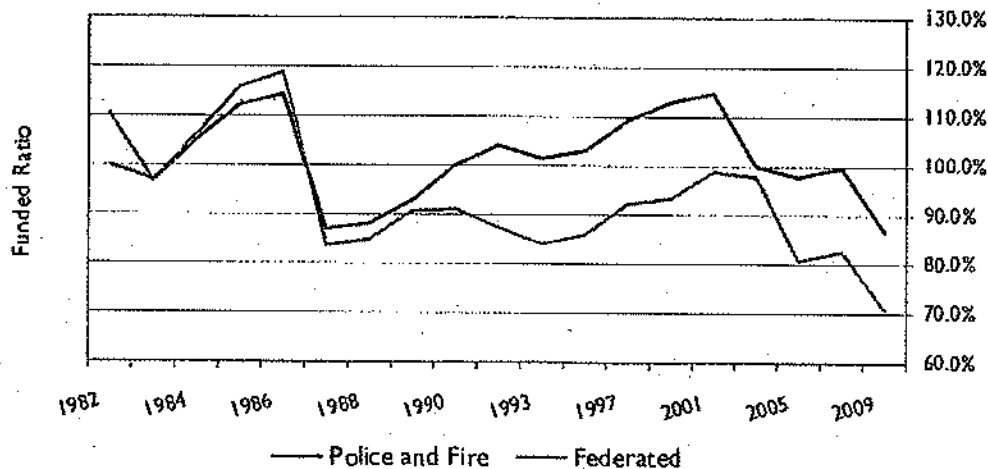
	Police and Fire	Federated
Market Value	66%	54%
Actuarial value	87%	71%

*Source: Auditor analysis of data from each retirement plan's actuarial valuations as of June 30, 2009*

## Pension Sustainability

As recently as June 30, 2007, the Police and Fire and Federated plans were considered 100 percent and 83 percent funded on an actuarial basis.<sup>20</sup> However, as shown in Exhibit 16, pension funded ratios as of 2008-09 are lower than at any actuarial valuation since 1981-82.

**Exhibit 16: Retirement Plans' Funded Ratios based on Actuarial Value of Assets, FY 1981-82 Through FY 2008-09**



Source: Actuarial Valuations and Annual Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 1981-82 through 2008-09

Chapter 4 includes more information about the growth in the City's unfunded pension liability.

### **The Declining Ratio of Employees to Retirees and Beneficiaries Creates a Risk of Even Higher Future Contribution Rates**

*When a pension system is fully funded, the ratio of workers to retirees matters little, because the money for retirees is already in the bank. But when a plan is underfunded, making the payouts can become extremely burdensome...<sup>21</sup>*

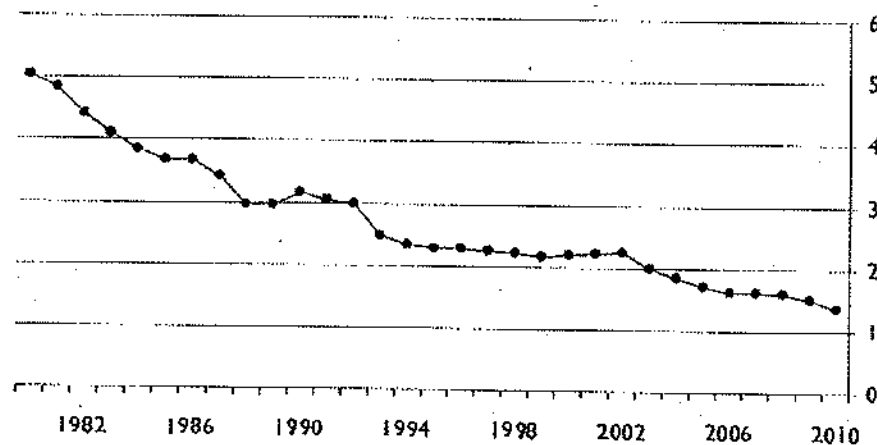
In FY 2009-10, there were 6,660 active employees compared to 4,891 beneficiaries, or roughly 1.4 employees to each beneficiary. The employee to beneficiary ratio was roughly 3 to 1 in FY 1990-91 and 5 to 1 in FY 1979-80.

<sup>20</sup> At that time, the Police and Fire OPEB obligation was estimated to be 7 percent funded, and the Federated OPEB obligation was estimated to be 16 percent funded on an actuarial basis (June 30, 2007 valuations).

<sup>21</sup> The Pew Center on the States, "Promises with a Price" (December 2007)

The result of a declining ratio is that with fewer active employees as a percentage of overall pension plan membership, the annual cost to pay down the *unfunded liability* (which is included in the City's annual contribution) is spread across the payroll of a declining pool of members. In that environment, pension contribution rates can become volatile when there are swings in asset values arising from investment gains and losses. Exhibit 17 shows the decline in the ratio of employees to retirees since the early 1980s.

**Exhibit 17: Decline in the Ratio of Employees to Retirees and Beneficiaries, FY 1980-81 Through FY 2009-10**



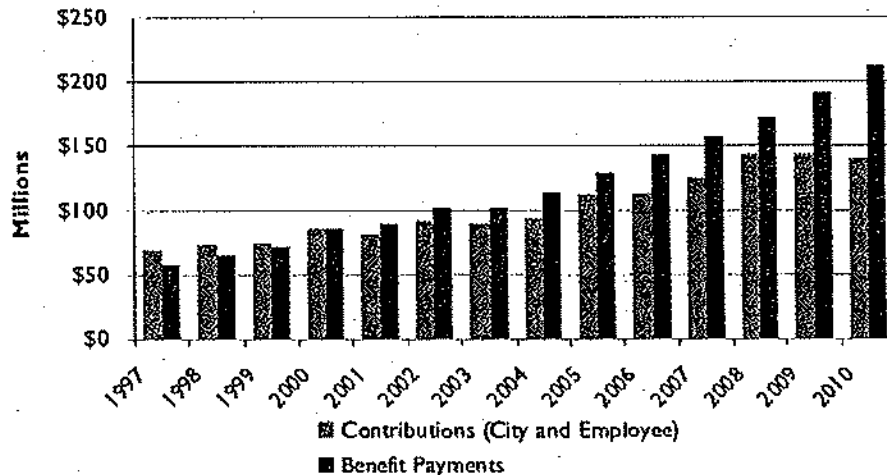
Source: Auditor analysis of data from Retirement Plan Comprehensive Annual Financial Reports, Annual Reports and actuarial reviews, Fiscal Years 1980-81 through 2008-09, Draft Fire Department Retirement Plan and Federated City Employees' Retirement System Financial Statements Fiscal Year 2009-10

**At Current Contribution Rates, Estimates Show the Amount Owed in Pension Liabilities Will Continue to Grow at a Much Faster Rate Than Available Plan Assets**

Pension payments to retirees are paid out of accumulated assets in the funds. As shown in Exhibit 18, current payments out of the pension funds have exceeded contributions for some time. This is to be expected in systems that are pre-funded and rely on investment returns to fund much of the future benefits.



**Exhibit 18: Pension Benefit Payments Have Exceeded Contributions Since 2001**



Sources: Comprehensive Annual Financial Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 2006-07 through 2008-09, Draft Police and Fire Department Retirement Plan and Federated City Employees' Retirement System Financial Statements Fiscal Year 2009-10

However, San José's plans are currently underfunded, and if contribution rates were frozen indefinitely at today's rates, even if investments yielded expected returns, Retirement Services staff estimate that the amount owed in pension obligations would continue to grow at a much faster rate than available plan assets, leading to ever increasing unfunded liabilities over the foreseeable future.

It is important to note that San José may be in better shape than some other retirement plan sponsors. According to Joshua Rauh of the Kellogg School of Management at Northwestern University, assuming states make contributions at recent rates and assuming they do earn 8 percent, 20 state funds will run out of cash by 2025; the first, will run dry in 2018.

## Chapter 3    **Rising Pension Costs Threaten the City's Ability to Maintain Service Levels**

### **SUMMARY**

Fiscal sustainability refers to whether the City can maintain current service levels without compromising service levels for future generations and whether the City can meet future obligations.

Currently, personnel costs such as salaries and compensation, employee benefits and retirement benefits account for about two-thirds of General Fund expenditures. The amount of personnel costs attributable to retirement contributions has increased over time. By FY 2014-15, annual pension and OPEB contributions are projected to reach 25 percent of total General Fund expenditures, up from 17 percent in FY 2010-11 and 6 percent in FY 2000-01.

Recent budget deficits required cuts to services, layoffs, and concessions from employee bargaining groups. Projected future deficits, in part because of rising pension costs, will require similar considerations. Continuing this trend of layoffs and pay and benefit reductions may make it difficult for the City to provide services and to retain and attract a quality workforce in the future.

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### **Fiscal Sustainability Should Be a Consideration For Any Decision on Whether the City Has Overcommitted on Pension Promises**

For many years, sustainability referred to the intersection between society's economic and environmental goals. According to the U.S. Environmental Protection Agency, "sustainability calls for policies and strategies that meet society's present needs without compromising the ability of future generations to meet their own needs."

More recently, the idea of sustainability has begun to inform decision making and reporting in other areas, including the fiscal sustainability of government entities. The Government Accounting Standards Board (GASB) began a research project in 2006 to identify the information needed by users of financial reports to assess a government's economic condition. Included in GASB's deliberation on the subject is the concept of fiscal sustainability. GASB wrote:

*At a very high level, long-term fiscal sustainability reporting involves an assessment of the extent to which service delivery can be maintained at existing levels, and the extent to which governmental obligations to*

## Pension Sustainability

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*citizens, under existing legal frameworks, can be met from predicted inflows over a predetermined future period.*

Fiscal sustainability is a key concept the City should consider as it determines whether it has overcommitted on pension promises. Specific questions to answer should be:

- Can the City maintain existing service levels without compromising service levels for future generations?
- Can the City meet its future obligations?

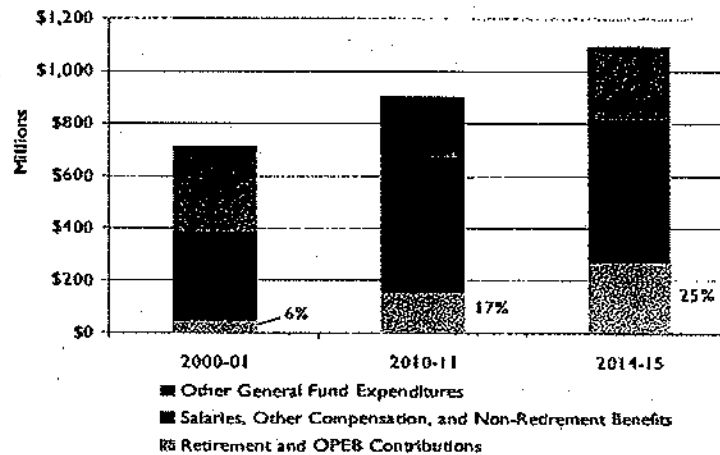
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### **About One Quarter of All General Fund Expenditure are Expected to Go Toward Retirement and OPEB Contributions by FY 2014-15**

Of the City's FY 2010-11 General Fund budgeted expenditures, about two-thirds are for personnel costs, including salaries, other compensation, and employee benefits. A growing portion of that personnel cost was funding for pension and OPEB costs.

According to the City Manager's economic forecasts, retirement and OPEB contributions are expected to be about 25 percent of total General Fund expenditures by FY 2014-15 (totaling about \$270 million). By comparison, they accounted for 17 percent of total General Fund expenditures in FY 2010-11 and 6 percent in FY 2000-01. Exhibit 19 shows the proportion of personnel costs, retirement and OPEB contributions, and other expenditures in the General Fund.

**Exhibit 19: Retirement and OPEB Contributions Compared to All Other General Fund Expenditures, FYs 2000-01, 2010-11, and 2014-15 (projected)<sup>22</sup>**



Source: Auditor analysis of data provided by the City Manager's Budget Office and from the 2011-2015 Five-Year Economic Forecast and Revenue Projections, February 2010

**Expected Growth in City Contribution Rates**

The increasing costs are a result of the expected growth in the City's contribution rates, which are shown in Exhibit 20.

<sup>22</sup> In the FY 2010-11 proposed budget, the budgeted amount of pension and OPEB contributions from all funds totaled about \$197.3 million. These figures are before reductions to the City's required contributions resulting from additional contributions offered by employee bargaining groups.

**Exhibit 20: The City's Share of Current and Future Estimated Contribution Rates as a Percent of Payroll**

	2010-11	2011-12 (est.)	2012-13 (est.)	2013-14 (est.)	2014-15 (est.)
Federated members:					
Pension	23.2%	27.1%	30.5%	34.0%	36.4%
OPEB	6.4%	7.2%	7.9%	8.7%	8.7%
Total	29.6%	34.3%	38.4%	42.7%	45.1%
Police members:					
Pension	38.3%	44.4%	51.3%	59.3%	64.3%
OPEB	6.3%	7.9%	9.3%	10.6%	10.6%
Total	44.6%	52.3%	60.6%	69.9%	74.9%
Fire members:					
Pension	40.2%	44.5%	51.3%	59.3%	64.3%
OPEB	3.9%	7.9%	9.3%	10.6%	10.7%
Total	44.1%	52.4%	60.6%	69.9%	75.0%

Note: these rates are before any negotiated employee pickup of a portion of the City's contribution rate. The above rates do not include the pre-payment discount rate.<sup>23</sup>

Source: Retirement Services Department and City Manager's Budget Office

As a comparison to these rates, the current combined cost for the employer and employee portions of Social Security and Medicare is 15.3 percent of pay.

#### **The City Has Seen Recent Budget Deficits and Projects More in the Future – Pension Costs Are a Major Factor**

In early 2010, San José's City Council was required to close a projected \$118.5 million deficit in the City's General Fund for FY 2010-11. Approximately \$52 million of that was attributable to higher than expected pension costs. To close the deficit, the Council was forced to cut services, lay off employees, and seek pay and other concessions from the City's employee bargaining units.

As part of its consideration of the FY 2010-11 Budget, the City Council directed the City Manager to begin discussions with employee bargaining groups to achieve a 10 percent reduction in total employee compensation. Total compensation includes base pay and benefits, including retirement contributions. Many employee bargaining groups agreed to reduce total compensation to save jobs and avoid service cuts.

<sup>23</sup> The pre-pay discount refers to a discount the City achieves by paying the full annual required contribution at the beginning of the year rather than throughout the year as the liability is accrued. The discount is a result of achieving the full year's investment earnings on contributions.

Some examples of actions taken included:

- Members of five unions, representing over 1,400 Federated members, agreed to increase their contributions into the retirement system towards the unfunded liability from 10.30 percent to 21.13 percent of their pay (or from \$10.30 for every \$100 of pay, to \$21.13 for every \$100 of pay). In comparison, Social Security contributions are set at 6.2 percent of pay.
- Police members agreed to increase their retirement contributions by 5.25 percent. This saved 70 police officer positions that had been designated for elimination. Total pension contributions by police members now equal 15.06 percent of pay.
- Many other employees had their base pay reduced, saw their medical and dental benefits reduced, and/or are being asked to take unpaid furlough days.

However, even with these concessions, 713 full-time equivalent positions were eliminated (leading to 191 full- or part-time employees being laid off) and services were reduced across the City. According to the City Manager's Budget Office, because one-time funds were used to continue many services in FY 2010-11, the full associated impact of some service cuts will not become effective until July 2011-12. This includes 217 positions to be eliminated at an annual net cost of \$22.2 million.<sup>24</sup>

As of August 31, 2010, the forecasted General Fund deficit for FY 2011-12 is \$41 million and continued deficits are forecast through FY 2014-15. To close projected budget deficits, the City Council will need to make decisions about cutting services, laying off employees, and negotiating with bargaining units, including retirement reform.

Continuing this trend of layoffs or reducing pay or benefits may make it difficult for the City to retain and attract a quality workforce in the future. Moreover, years of successive budget reductions are cutting City services to the core.

<sup>24</sup> For more information see 2010-2011 Adopted Budget in Brief at <http://www.sanjoseca.gov/budget/FY1011/2010-2011AdoptedBudgetinBriefFINAL.pdf>.

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## Chapter 4 The City's Unfunded Pension Liability Has Grown Dramatically in Recent Years

### SUMMARY

As of June 30, 2009, the City's pension liability was \$5.4 billion. That is, the City had promised to pay an estimated \$5.4 billion in retirement benefits to current employees and retirees. However, the City did not have enough in the two retirement funds to meet its promises and was \$2 billion short (on a market value basis) of the amount it should have set aside to meet those expectations.

One reason for the rise in the *unfunded pension liability* was investment losses of about \$978.8 million incurred from 2007-2009. In spite of recent investment gains of \$512 million, those losses will continue to affect the City's *unfunded liability* over the next few years because of the actuarial method of recognizing or *smoothing* gains and losses over five years to minimize the effect that market swings have on contribution rates.

Another reason for the rise in the *unfunded pension liability* was the retroactive application of benefit enhancements, such as in 2006 and 2008 when retroactive benefit enhancements for Police and Fire members created more than \$70 million in *unfunded liabilities*. Because San José residents are ultimately responsible for pension costs and the fact that *unfunded liabilities* can result from retroactive benefit enhancements, we recommend the City Council consider prohibiting:

1. Pension benefit enhancements without voter approval
2. Retroactive pension benefit enhancements that create *unfunded liabilities*

However, another significant reason for the rise in the *unfunded liability* is that *actuarial assumptions* used to calculate the City's *pension liabilities* did not hold true. These assumptions represent expectations about future events and include such things as the plans' investment returns, member mortality and retirement rates, and salary increases. Because the plans' *actuarial assumptions* did not hold true and certain assumptions were adjusted based on past experience, the *unfunded liability* increased by about \$750 million between June 30, 2007 and June 30, 2009.

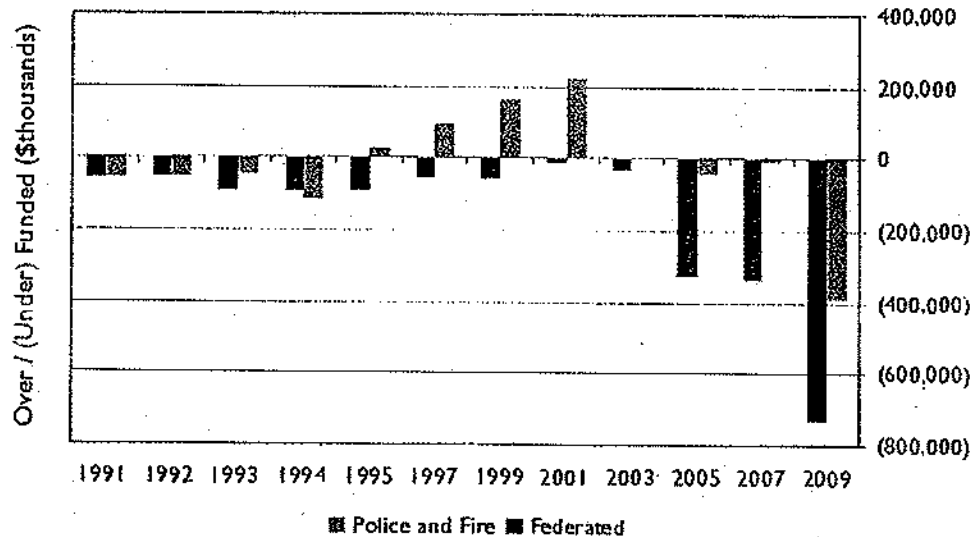
To ensure the reasonableness of the methods and assumptions used in the retirement plans' *actuarial valuations*, we recommend that the City Council amend the Municipal Code to require an actuarial audit of such valuations every five years if the *actuary* conducting the valuation has not changed in that time.



**As of June 30, 2009, the City Had a \$2 Billion Unfunded Pension Liability**

As shown in Exhibit 21, the Retirement Plans' funded status has deteriorated significantly since 1990-91.

**Exhibit 21: Retirement Plans' Funded Status (Unfunded Actuarial Accrued Liability), FY1990-91 Through FY 2008-09**



Source: Actuarial Valuations and Annual Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 1990-91 through 2008-09

By June 30, 2009, the City's *unfunded pension liability* totaled about \$2 billion based on market value.<sup>25</sup> On an actuarial basis, the unfunded liability was about \$1.1 billion. However, because only a portion of the recent market losses have been recognized for actuarial purposes (as a result of smoothing market gains and losses over time), these costs will rise further in the coming years when the remaining losses are recognized. For 2010-11, the annual cost to pay this down added roughly:

- 13 to 14 percent of payroll to the City's annual contribution for Police and Fire members (or about \$34 million)
- 11 percent of payroll to the City's annual contribution for Federated members (or about \$35 million)

*Unfunded liabilities* in government pensions arise for a number of reasons, primarily because (1) the government did not fund benefits earned by employees

<sup>25</sup> In addition to the pension plans' unfunded liability, the City also has \$1.4 billion in unfunded liabilities (on a market value basis) as a result of promised OPEB benefits as described in Chapter 2.

each year, (2) new benefits are added, or (3) *actuarial assumptions*, or expectations, about key economic and demographic factors which determine contribution rates (e.g. investment returns, rates of member retirement or mortality) do not match actual outcomes. In San José, the City saw both (2) and (3) occur.

#### **The Importance of Fully Funding the Annual Required Contribution for Pension Benefits**

Unlike some jurisdictions, the City has generally been fully funding its *annual required contributions* for pension benefits. The plans have had *actuarial valuations* completed on a regular biennial schedule and, with the exception of two years in the 1990s, has consistently made its *annual required contribution (ARC)*.<sup>26</sup> The plans recently changed to having annual valuations. Furthermore, the City is moving towards fully funding the ARC for retiree healthcare.

Recent newspaper articles are replete with stories of other jurisdictions that have not funded their annual required pension contributions and who have made little effort to fund their OPEB liabilities. As a result, current and future taxpayers will be on the hook to pay those costs.

Fully funding the annual required contribution for pension benefits is not just an important budgetary choice; it also addresses the concept of inter-generational or inter-period equity. As discussed later, intergenerational equity is the concept that current-year costs should be recognized and paid in the current year, and not shifted off to future taxpayers.

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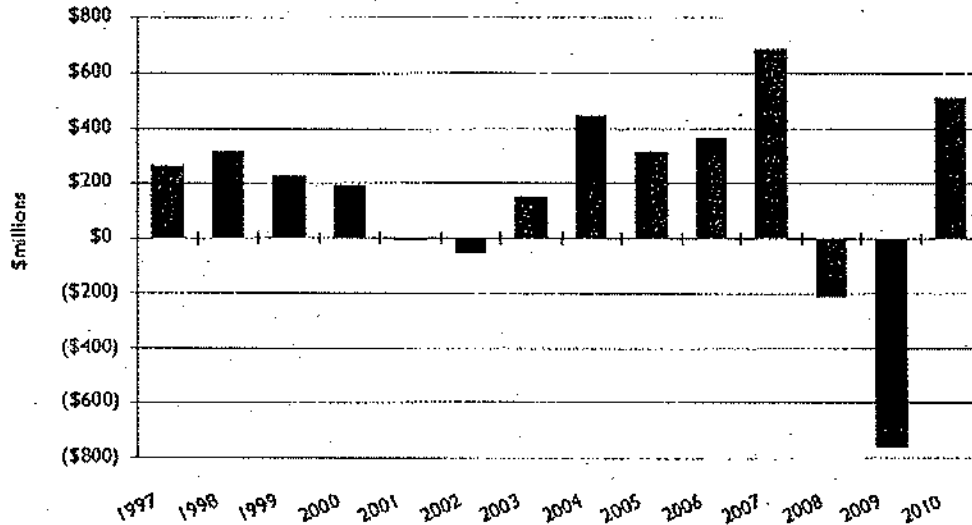
#### **Retirement Plans Have Experienced Large Market Losses in Recent Years, Increasing the Unfunded Pension Liability**

There is, of course, no guarantee that even a fully funded pension plan will stay that way. As a result of the recent economic downturn, the combined investment losses of both plans totaled more than \$765 million in FY 2008-09. This is in addition to \$214 million in losses from the previous year. In FY 2009-10 the combined investment gains of both plans totaled \$512 million. Because they are generally assumed to generate the majority of assets over time, investment earnings are an extremely important component of a pension plan's viability. Exhibit 22 shows the investment gains and losses between FY 1996-97 through FY 2009-10.

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<sup>26</sup> In those two years, the City made 92 percent and 96 percent of the total ARC for the Federated Plan. The reasons were that (1) the City opted to phase in a recommended contribution rate increase and (2) the City elected to defer funding for the reciprocity benefit provided in 1994 as the actuaries were unable to adequately value the liability because a lack of reliable data.

**Exhibit 22: Retirement Plans' Investment Gains and Losses, FY 1996-97 Through FY 2009-10**



Sources: Comprehensive Annual Financial Reports, Police and Fire Department Retirement Plan and Federated City Employees' Retirement System, Fiscal Years 1996-97 through 2008-09, Draft Police and Fire Department Retirement Plan and Federated City Employees' Retirement System Financial Statements Fiscal Year 2009-10

#### **Even Strong Returns May Not be Able to Make Up for Recent Losses**

During FY 2009-10, each plan saw strong net investment returns, 15.3 percent for Federated and 13.7 percent for Police and Fire. However, because of the nature of compounded interest, even strong returns such as these may not fully offset past losses. Following is an example to highlight this. If a \$100 investment loses 20 percent of its value in year one, the balance is \$80. If in year two the investment earns a 20 percent return the value of the investment is only \$96, not \$100. To get back to even, the investment would need to earn a 25 percent return on investment in the second year (\$20 divided by \$80).

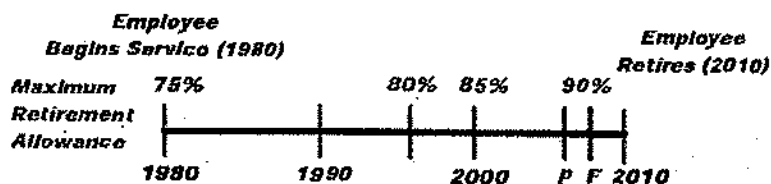
#### **Retroactive Benefit Enhancements Have Also Increased the Unfunded Pension Liability**

Another reason for the increase in the unfunded liability is that each plan has had benefits enhanced over time, often retroactively over current members' entire careers. Retroactive benefit enhancements create a liability for pension obligations which had not been previously funded through prior years' contributions.

For example, in 2006 and 2008, the maximum allowable benefit for Police and Fire members was increased from 85 percent of final compensation to 90 percent and this was applied retroactively to all active members. This enhancement added about \$70 million to the Police and Fire *unfunded liability* (or about \$26,000 per Police member and \$47,000 per Fire member). It should be noted that the 2008 increased benefit for Fire members was granted by an Arbitration Board through the Charter's binding interest arbitration procedures.

The following example illustrates how a retroactive benefit enhancement creates *unfunded liabilities*. Exhibit 23 shows a timeline for a sworn Fire employee who began working with the City in 1980 and retired in 2010 with a final compensation equaling \$100,000. Because this individual worked for 30 years, they receive the maximum allowable benefit of 90 percent of final compensation (or a pension equal to \$90,000).

**Exhibit 23: Example of How Retroactive Benefit Enhancements Would Affect a Fire Employee Retiring in 2010 After 30 Years of Service**



Source: Auditor analysis of the San José Municipal Code

During the employee's service, the maximum benefit level was changed three times:

- 1996 – maximum benefit was raised from 75% of final compensation to 80%
- 2000 – maximum was raised from 80% to 85%
- 2008 – maximum was raised from 85% to 90%

For most of this employee's career, both employee and City contributions were made to fund a lesser level of benefits. When the maximum allowable pension was increased in 2008 and applied retroactively, it created an *unfunded liability* equaling the difference between the level of assets required for an annual \$90,000 pension and that required to fund a \$75,000 or \$85,000 pension. Historically, the unfunded liability for these types of retroactive benefit enhancements has been the sole responsibility of the City.

Benefit enhancements can be granted by the City Council or, in the case of Police and Fire members, through the binding arbitration process. Because taxpayers are ultimately responsible for future pension benefits, jurisdictions such as San Francisco and San Diego only allow benefit enhancements to occur through voter approval.

The state of Maine has a clause in its constitution stating that *unfunded liabilities* in its state retirement system may not be created except those resulting from *experience losses* (see next section for discussion of *experience losses*). The effect of this is that retroactive benefit enhancements cannot be granted if they create any *unfunded liability*.

**Recommendation #1: We recommend the City Council explore prohibiting:**

1. Pension benefit enhancements without voter approval
2. Retroactive pension benefit enhancements that create unfunded liabilities

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### **The Unfunded Liability for Pensions Increased by About \$750 Million Because Actuarial Assumptions That Had Been Used to Cost the Plans Did Not Hold True**

A key objective of retirement planning is to strive for prefunded benefits, meaning contributions are made during the course of an employee's career such that those contributions (along with investment earnings) pay for the entire cost of the employee's pension benefits. As discussed earlier, this prefunding is important for inter-period equity, i.e. the concept of paying for current services and not shifting the burden onto future taxpayers.

#### **The Role of Actuarial Assumptions in Calculating Pension Liabilities and Contribution Rates**

When actuaries conduct valuations to calculate *pension liabilities* and contribution rates, they make assumptions about future events that affect the amount and timing of benefits to be paid and assets required to be accumulated. These assumptions relate to such variables as:

- Future investment returns on plan assets
- Member mortality rates
- Member retirement rates
- Expected salary increases by members
- Additional variables such as disability rates, termination rates, and other factors which can impact future benefit calculations

When *actuarial assumptions* do not hold true, a plan's *unfunded liability* may grow. For example, if a beneficiary lives longer than expected, they will receive more benefits than predicted. The costs of these unexpected benefits will result in a higher pension liability. When conducting an *actuarial valuation*, actuaries recognize *experience gains or losses*, depending on whether actual outcomes as compared to the assumptions result in a lower or higher calculated liability.

Actuaries may also change assumptions to reflect changing expectations of the future. Changing assumptions also result in adjustments to the pension liability as they impact projected experience in all future years (as such, they also affect the plan's *normal costs*).

#### **The Unfunded Liability Increased by More Than \$220 Million Because Investment Returns Fell Below Expectations**

The current assumption for net investment return is 8.0 percent for Police and Fire. Federated's prior assumption of 8.25 percent is being stepped down to 7.75 percent over the next 5 years. When investment returns do not meet these expectations, the plans' must recognize *experience losses*. These *experience losses* are distinguished from the market losses discussed earlier. *Experience losses* are the difference between actual investment returns and what is expected to occur as represented by the actuarial assumption.

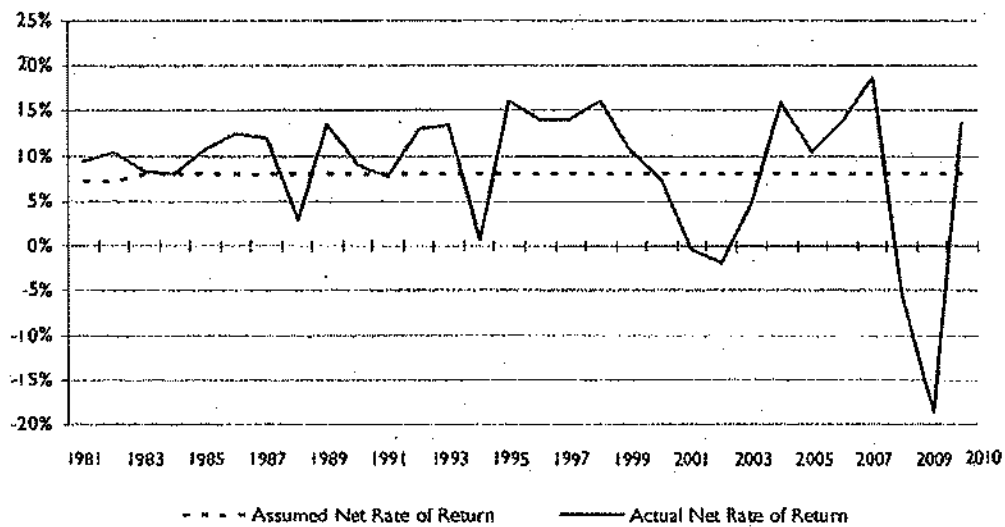
It is important to compare the actual investment return to the assumed return because, as was reported by the Pew Center on the States in *The Trillion Dollar Gap*, if a plan suffered a one-time, 24 percent loss in value:

*... the fund would have to make 16 percent in annual investment returns for the next five years to accumulate as much as would have been accrued if they had consistently received the historically anticipated 8 percent rate of return over the same period of time.<sup>27</sup>*

Exhibits 24 and 25 show the assumed investment returns and estimated actual net returns from FY 1980-81 through FY 2009-10 for each plan.

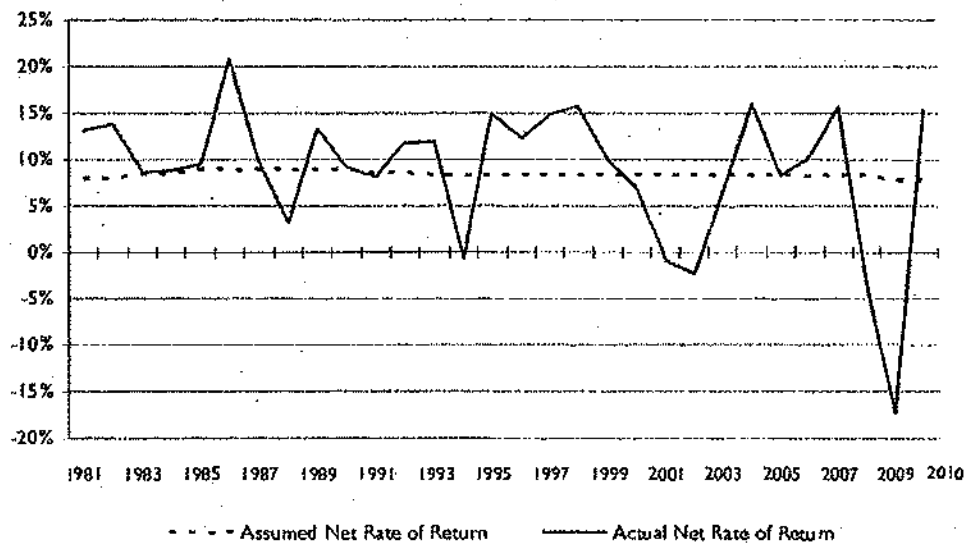
<sup>27</sup> The Pew Center on the States, "The Trillion Dollar Gap" (February 2010)

**Exhibit 24: Police and Fire Retirement Plan Assumed and Actual Net Investment Returns, FY 1980-81 Through FY 2009-10**



Sources: Comprehensive Annual Financial Reports, Annual Reports and actuarial valuations, Police and Fire Department Retirement Plan, Fiscal Years 1980-81 through 2008-09, Draft Police and Fire Department Retirement Plan Financial Statements Fiscal Year 2009-10

**Exhibit 25: Federated City Employees' Retirement System Assumed and Actual Net Investment Returns, FY 1980-81 Through FY 2009-10**



Sources: Comprehensive Annual Financial Reports, Annual Reports and actuarial valuations, Federated City Employees' Retirement System, Fiscal Years 1980-81 through 2008-09, Draft Federated City Employees' Retirement System Financial Statements Fiscal Year 2009-10

Through FY 2009-10, each plan had met its assumed net investment return in 22 of the past 30 years. However, in each case the plans failed to meet the assumed return in 5 of the previous 10 years. Over the last thirty years, the long-term compound growth rates for both plans were about 7.5 percent.

Between June 30, 2007 and June 30, 2009, actuarial experience losses from investment returns added about \$138 million to the Police and Fire unfunded liability and \$86 million to the Federated unfunded liability (about \$36,000 per Police and Fire member and \$11,000 per Federated member<sup>28</sup>).

**The Unfunded Liability Increased by More Than \$160 Million Because Other Demographic and Economic Assumptions Did Not Hold True**

According to experience analyses prepared by the plans' actuaries in 2009, other demographic and economic assumptions did not hold true.

- Police and Fire – the plan experienced earlier retirements and higher salary increases among active members than expected.<sup>29</sup>
- Federated – the plan experienced more retirements, more terminations and withdrawals, and fewer salary increases than expected.

As a result, the contribution rates had been set too low, and the plans fell further behind. Experience losses associated with these assumptions for the two years ending June 30, 2009 added about \$105 million to the Police and Fire unfunded liability and \$62 million to the Federated unfunded liability (about \$27,500 per Police and Fire member and \$8,000 per Federated member).

**The Unfunded Liability Increased by More Than \$370 Million Because Some Mortality Rate, Retirement Rate, Salary Increase, and Investment Rate Assumptions Were Adjusted Based on Past Experience**

Changing assumptions can have a large impact on the calculation of pension liabilities. As a result of the experience analyses and Retirement Services staff advocating for more realistic assumptions, the actuaries for each plan recommended, and the Boards' approved, changes to key plan assumptions for the June 30, 2009 valuations.<sup>31</sup> These changes added about \$145 million and \$229 million to the Police and Fire and Federated unfunded liabilities respectively (about \$38,000 per Police and Fire member and \$29,000 per Federated member).

<sup>28</sup> Member includes retired members, survivors, and active employees.

<sup>29</sup> As noted earlier, because of the actuarial method of smoothing gains and losses, recent market losses have not been fully recognized for actuarial purposes.

<sup>30</sup> The assumption was for annual salary increases to range from 5% to 9% depending upon years of service. Actual average salary increases over the 4-year study period ranged from 7.3% to 11.6%.

<sup>31</sup> In recent years, Retirement Services has hired two actuaries for its staff.



## Pension Sustainability

### Specific changes included:

- Police and Fire Plan – (1) mortality rate was changed to reflect longer expected lives of plan members, (2) retirement rate for Police members was adjusted to reflect earlier retirements, and (3) salary increase assumption was changed to reflect higher salary increases.
- Federated Plan – (1) begin phase-in for reduction in long-term investment rate of return assumption from 8.25 percent to 7.75 percent and (2) mortality rate assumption was changed to reflect longer lives.

Because recent market losses have not been fully recognized for actuarial purposes, the actuarial unfunded liability totaled \$1.1 billion at June 30, 2009 (or about \$1 billion less than the market value of the unfunded liability). Even with the deferral of market losses, however, the City's actuarial unfunded liability grew by \$778 million between 2007 and 2009 as a result of experience losses and assumption changes.

Exhibit 26 shows the components of the growth in the two plans' actuarial unfunded liabilities from June 30, 2007 to June 30, 2009 along with the amount of deferred losses to be recognized in the future.

**Exhibit 26: Components of the Growth in the Actuarial Unfunded Liability from June 30, 2007 to June 30, 2009 (\$millions)**

	Police & Fire	Federated	Total
Actuarial Unfunded liability, June 30, 2007	\$ 6.6	\$ 338.1	\$ 344.7
Investment experience losses (actual return less than assumed return—as opposed to market losses which have not been fully recognized for actuarial purposes)	138.4	86.5	224.9
Other outcomes differing from assumptions (e.g. member mortality and retirement rates, salary increases)	105.1	62.2	167.3
Change in investment return assumption	-0-	141.5	141.5
Changes in other assumptions: Police and Fire – mortality and retirement rates, salary increases Federated – mortality rate	145.4	87.3	232.7
Amortization of previous unfunded liability	(1.6)	-0-	(1.6)
Interest costs and other	-0-	14.0	14.0
Actuarial Unfunded liability, June 30, 2009	393.9	729.6	1,123.5
Deferred losses	600.4	399.9	1,000.3
Unfunded liability (market value), June 30, 2009	\$ 994.3	\$ 1,129.5	\$ 2,123.8

Source: Auditor analysis of June 30, 2009 Actuarial Valuations for San José's two retirement systems

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**Recommended Best Practice: Actuarial Audits**

According to the Police and Fire actuary, The Segal Company, the use of realistic *actuarial assumptions* is important to maintain adequate funding, as estimating as closely as possible to the actual cost "will permit an orderly method for setting aside contributions today to provide benefits in the future, and to maintain equity among generations of taxpayers and participants."

As is evident from recent history, when *actuarial assumptions* do not hold true, unfunded liabilities and contribution rates can increase dramatically. The Government Finance Officers Association's (GFOA) recommends that retirement plans have an independent *actuary* conduct an audit of the plan's *actuarial valuations* at least once every five to eight years. The purpose of the actuarial audit is "to provide an independent critique of the reasonableness of the actuarial methods and assumptions in use and the validity of the resulting actuarially computed contributions and liabilities."

Other jurisdictions, including the states of Washington and Missouri, have specific policies which require regular, periodic actuarial audits. In San José, only when the retirement plans change actuaries are the *actuarial valuations* subjected to such peer-level scrutiny.

**Recommendation #2:** To ensure the reasonableness of the methods and assumptions used in the retirement plans' actuarial valuations, we recommend that the City Council amend the Municipal Code to require an actuarial audit of such valuations every five years if the actuary conducting the valuation has not changed in that time.

**GASB Project Plan: Postemployment Benefit Accounting and Financial Reporting**

In 2006, GASB launched a research project to gather information regarding how effective the standards established for pension accounting and financial reporting—Statement No. 25, *Financial Reporting for Defined Benefit Pension Plans and Note Disclosures for Defined Contribution Plans*, and Statement No. 27, *Accounting for Pensions by State and Local Governmental Employers*—have been in improving accountability and providing decision-useful information.

GASB has issued its preliminary views and proposed changes on pension accounting and financial reporting. Retirement Services staff have already conducted a preliminary analysis of how the proposed changes would impact the City's financial reporting and accounting of post-employment benefits:

## Pension Sustainability

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- The unfunded liability would be recognized as a liability on the City's balance sheet. The liability would be defined as the difference between the *actuarial accrued liability* and the net market value of assets.
- Because the City's annual expense calculation may be calculated differently than the current annual required pension contribution, the changes could potentially add volatility and introduce a disconnect between the two.

However, it should be noted that new standards regarding pension accounting have not yet been issued by GASB and are probably years away from implementation.

## **Chapter 5 Individual Components of the City's Pension Plans Have Different Impacts on Overall Costs**

### **SUMMARY**

Each component of a pension plan has an impact on the overall cost of the system. In addition to the pension formulas (expressed as a set percentage multiplied by a member's years of service), two major drivers of the City's pension costs are:

- Age at which members are eligible to receive retirement benefits (50 for Police and Fire and 55 for Federated)
- Each plan's guaranteed annual 3 percent cost-of-living adjustment (COLA).

Other cost drivers with varying degrees of impact include the determination of final average salary using the highest one-year average, joint and survivor benefits, the maximum pension levels (90 percent for Police and Fire and 75 percent for Federated), the plans' reciprocity provisions, and the Supplemental Retiree Benefit Reserves.

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### **Retirement Age and the Guaranteed 3 Percent COLA Are Major Cost Drivers of the City's Pension Plans**

Each component of a pension plan has an impact on the overall cost of the system. In conjunction with our review, we asked Retirement Services staff to assess the relative costs of various components of the City's pension plans as a proportion of the overall cost. The following are not designed as specific proposals for change; they are meant to give a general picture of what plan provisions are driving pension costs. Specific elements of the current plans' designs included in the analysis were:

- Retirement age
- Pension formulas, including maximum allowable benefit
- COLA
- Final compensation

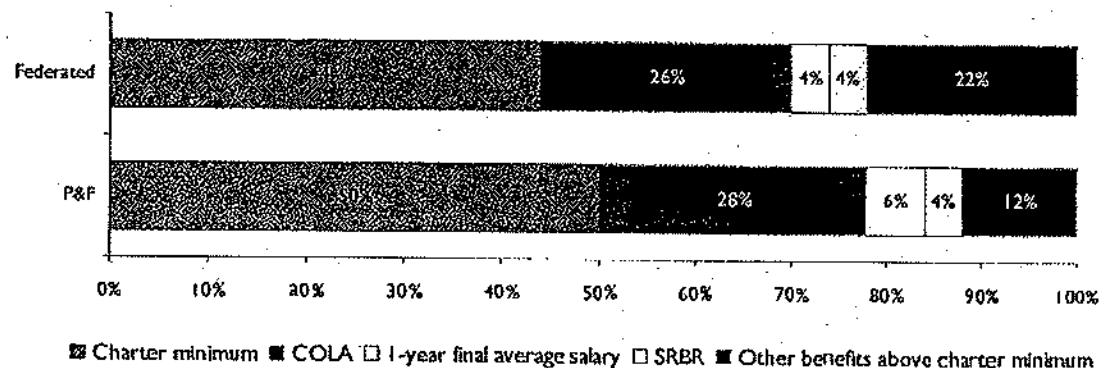
- Standard allowance to surviving spouse/domestic partner or children ("joint and survivor benefits")

#### Estimated Cost of Charter Minimum and Other Selected Provisions

For Police and Fire, the Charter minimum benefit equals 50 percent of final compensation; the Federated minimum benefit equals 2 percent of final compensation for the first 25 years of service plus 1 percent for each year beyond 25 (with a maximum benefit of 85 percent of final compensation). For each plan, the Charter defines final compensation as the average salary in the three years immediately preceding the member's retirement.

Exhibit 27 highlights the cost components of the current plans. As shown in Exhibit 27 the minimum benefits spelled out in the Charter account for an estimated 44 to 50 percent of the total cost of each plan. The guaranteed 3 percent COLA, which is not part of the Charter minimum benefit, accounts for an additional 26 to 28 percent of the cost of each plan. The one-year final compensation for determining pension benefits accounts for 4 to 6 percent of cost, and the SRBR accounts for an estimated 4 percent of each plan's cost.

**Exhibit 27: Estimated Percentage of Current Plan Costs Attributable to Charter Minimums and Other Selected Provisions**

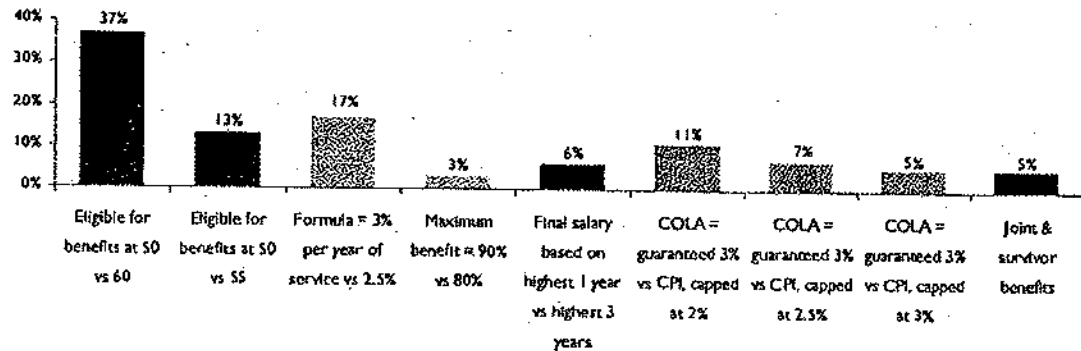


Source: Retirement Services Department

Note: Costs are estimated based on current active membership and actuarial assumptions used for the June 30, 2009 valuations.

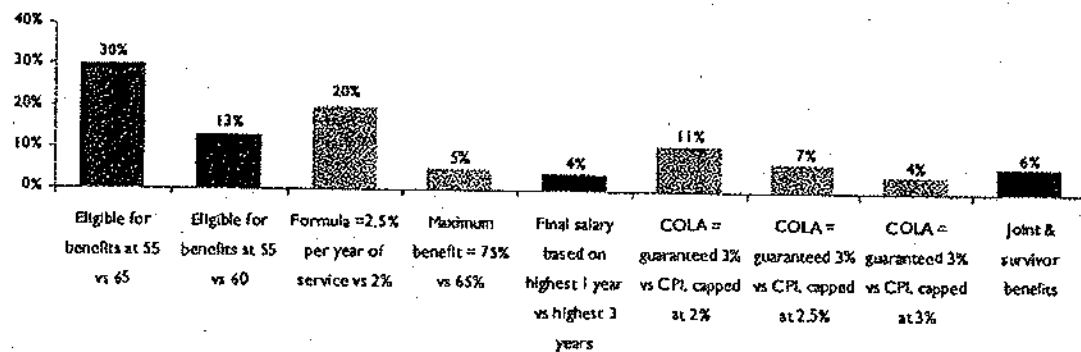
#### Estimated Cost of Various Benefit Levels

Exhibits 28 and 29 show estimated costs attributable to various benefit levels, including the retirement age, the COLA, pension formulas, joint and survivor benefits, and the highest one-year average final salary versus the highest three-year average.

**Exhibit 28: Estimated Costs Attributable to Various Benefit Levels – Police and Fire**

Source: Retirement Services Department

Note: Costs are estimated based on current active membership and actuarial assumptions used for the June 30, 2009 valuations. CPI-capped COLA costs were estimated using annual CPI over the last 50 years assuming no COLA banks.

**Exhibit 29: Estimated Costs Attributable to Various Benefit Levels – Federated**

Source: Retirement Services Department

Note: Costs are estimated based on current active membership and actuarial assumptions used for the June 30, 2009 valuations. CPI-capped COLA costs were estimated using annual CPI over the last 50 years assuming no COLA banks.

These cost components are described in more detail below:

#### Retirement Age

As is shown in Exhibits 28 and 29, one of the largest cost drivers is the age at which retirees are eligible to receive benefits – more than 30 percent of total cost comes from the eligibility to retire at 50 and 55 years of age versus 60 and 65 year of age for Police and Fire and Federated, respectively.

The Police and Fire retirement age was decreased from age 55 to age 50 in 1968. The Federated retirement age of 55 or older with 5 years of service, or any age with 30 years of service, has been in place since 1975. Eligibility to retire at 50 versus 60 years of age increases Police and Fire costs by about 37 percent. Eligibility to retire at 55 versus 65 years of age increases Federated costs by about 30 percent.

Increasing or reducing the retirement age has the effect of changing both the number of years a retiree receives benefits and the number of years that they contribute into the system prior to retirement. Among retirees as of June 30, 2009 the median retirement age for Police and Fire retirees was 54 and the median retirement age for Federated was 56. By comparison, eligibility for Social Security benefits begins at age 65 (or 62 for a reduced, early benefit) or 67 for individuals born after 1960.

Locally and across the country, consideration is being given to increasing retirement ages. For example, in 1983, the Federal government approved phasing in increased Social Security retirement ages in an effort to shore up the Social Security Trust Fund.

#### **Pension Formulas, Including Maximum Allowable Pension**

Pension formulas determine how the actual benefit is calculated. The maximum allowable benefit provides a ceiling on the level of benefit that is allowable (before the application of any COLA). As shown in Exhibit 29, Retirement staff estimate that pensioning employees at 2.5 percent instead of, say, 2 percent increases Federated costs by about 20 percent, and that pensioning Police and Fire employees at 3 percent rather than 2.5 percent increases costs by about 17 percent. On the other hand, reducing the maximum benefit to, say 65 percent of final salary rather than 75 percent could reduce Federated costs by about 5 percent.

#### **Guaranteed Annual Increases (a.k.a. COLAs)**

San José's pension plans provide guaranteed annual cost-of-living increases, even in the first year of members' retirement. The current system provides that all pensions in effect as of February 1<sup>st</sup> (Police and Fire) and April 1<sup>st</sup> (Federated) receive an automatic 3 percent increase. As a result, a Police and Fire member can retire on January 31<sup>st</sup> at 90 percent of salary and receive a 3 percent increase the next day, resulting in a pension of 92.7% of final salary.

This fixed COLA was negotiated in 2002 and 2006 for Police and Fire and Federated respectively, and replaced a previous benefit that was tied to the Consumer Price Index (CPI) and capped at 3 percent. In years that the CPI was greater than 3 percent, the excess was banked to offset years in which the CPI was lower than that mark.

As shown above in Exhibit 27, Retirement staff estimate the guaranteed COLA accounts for about 28 percent of the total cost of the Police and Fire plan, and 26 percent of the total cost of the Federated plan. As shown in Exhibits 28 and 29, the guaranteed 3 percent COLAs cost an estimated 11 percent of pay more than would a COLA based on the CPI and capped at 2 percent.

#### Determination of Final Compensation

Both plans have changed their determination of final compensation from highest three-year average compensation to highest 12-month average compensation. Although the highest one-year provision took effect in 1970 for Police and Fire, the Federated benefit was changed more recently, in 2001.

Exhibit 30 shows a recalculation of what three sample Federated retirees' pension would be using a three-year average when computing final average salary compared to the actual current benefit calculation.

**Exhibit 30: Potential Lifetime Savings Using Highest Three-Year Average as Final Compensation**

Sample Federated Retiree	Current Monthly Pension	Monthly Pension Using Highest Three-Year Average	Potential Life Savings Using Three-Year Average (w/COLA)
Retiree #1	\$9,673	\$9,300	\$247,958
Retiree #2	\$2,098	\$2,047	\$44,224
Retiree #3	\$1,992	\$1,874	\$58,071
Total Potential Life Savings			\$350,253

Source: Auditor analysis based on information obtained from Pension Gold and PeopleSoft.

As shown earlier in Exhibits 27, Retirement Services staff estimates the cost of determining final salary from the highest one-year average salary versus the highest three-year average salary costs about 6 percent and 4 percent for Police and Fire and Federated respectively.<sup>32</sup>

#### Standard Joint and Survivor Benefits

Both plans have standard joint and survivor benefits that increase estimated pension plan liabilities by about 5 to 6 percent (see Exhibits 28 and 29). For each plan, spouses or domestic partners are eligible for up to 50 percent of a member's pension after the member's post-retirement death. Surviving children are also provided benefits if they are minors or students up to the age of 22.<sup>33</sup>

<sup>32</sup> As noted in the *Audit Objective, Scope, and Methodology* section of this report, the City Auditor's Office has previously recommended the City return to using a three year average in pension calculations rather than the highest compensation earnable in any twelve month period.

<sup>33</sup> Note that retirees may choose an optional settlement at retirement that reduces their pension benefit to provide a higher survivorship allowance to a designated beneficiary or their spouse/domestic partner.



**Other Cost Elements**

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Two other elements of the City's retirement plans also add costs to the pension systems:

**Reciprocity**

In 1994, the City entered into an agreement with CalPERS that extends reciprocal benefits to plan members. Reciprocity allows members to combine their service with the City with reciprocal CalPERS systems to determine total years of service and final compensation. In FY 2010-11, reciprocity added 0.45 percent of payroll to the current Federated contribution rate (adding about \$1.5 million per year to the City's *annual required contribution*).

**Supplemental Retiree Benefit Reserves (SRBR)**

The SRBRs allow for supplemental benefits to retirees which are derived from plan "excess" earnings. When the plans actual investment returns exceed the expected returns, then a portion is transferred into the SRBR for later distribution as a supplemental benefit. This is expected to take place even when the plan is underfunded. The Federated SRBR was established in 1986; the Police and Fire SRBR was established in 2002. Each plan had a funded ratio greater than 100 percent the year their respective SRBRs were established.<sup>34</sup>

Retirement Services staff estimates that the cost to the Retirement Funds to transfer "excess" earnings to the SRBR is about 0.3 percent of earnings. That is, if the plan is normally expected to earn 8.0 percent in investment earnings in the long term, it will need to actually earn about 8.3 percent to account for SRBR transfers for the years when the plan exceeded 8.0 percent. As was shown in Exhibit 27, the SRBRs account for about 4 percent of the total costs of each plan.

For FY 2009-10, each plan had net investment earnings in excess of the expected returns. Retirement Services staff estimates that there may be "excess" earnings for Federated, meaning there may be a transfer of income into the SRBR even though the plan has a significant underfunded liability. As of August 31, 2010, there had not been a determination of whether there would be a distribution to Federated retirees however. For Police and Fire, the calculation of excess earnings is slightly different and Retirement Services staff does not believe that there will be "excess" earnings for FY 2009-10.

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<sup>34</sup> The parameters for when each plan makes a distribution to retirees differ and distributions are not made every year. In general, when distributions are made, the amount per retiree depends on years of service and years retired. As of June 30, 2010, the balance in the SRBR for Police and Fire is \$32.3 and for Federated is \$21.3 million.

## Chapter 6 Alternatives for a Sustainable Future

### SUMMARY

The City has limited maneuverability in how it could change its pension plans for current employees. Nonetheless, the City may be able to or may have to reduce its pension costs to preserve the system. Other jurisdictions have reduced their costs through (1) additional cost sharing by employees, (2) prospective changes in plans for existing employees, and (3) establishing a second tier pension for new hires. We recommend the City pursue one or a combination of these cost-containment strategies, and that the City consider eliminating the SRBRs or at least prohibiting transfers into the SRBRs and distribution of supplemental benefits when the plans are underfunded, and also consider joining CalPERS in order to reduce administrative costs.

Finally, because of rising pension costs and their threat to the City's General Fund, we recommend that the City Manager should propose an annual ongoing budget for actuarial services to ensure that any cost projections for negotiations with bargaining groups are actuarially sound and to assess the long-term sustainability of any proposed plan revisions.

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#### Maneuverability to Change Plans for Current Employees is Limited Under Current Law

There is considerable discussion about how limited the City or other local governments are in changing certain benefits for active members of retirement plans. The City's maneuverability to change its pension plans for active employees may be restricted as it could be deemed an impairment of an existing contract.<sup>35</sup> In this situation, San José is not unique. According to a recent New York Times article:

*There is, of course, no argument for canceling a pension already earned. But public employees benefit from a unique notion that, once they have worked a single day, their pension arrangement going forward can never be altered. No other Americans enjoy such protections. Private companies often negotiate (or force upon their workers) pension adjustments.<sup>36</sup>*

However, not every benefit was authorized or "promised" in the same way, and some things can be more easily modified than others (e.g. employee contribution

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<sup>35</sup> The vested rights doctrine may have different application to retiree medical benefits for current employees than pension benefits for current employees.

<sup>36</sup> Roger Lowenstein, *The Next Crisis: Public Pension Funds* (June 2010)

## Pension Sustainability

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rates) and additional analysis will be required. There are currently lawsuits challenging the assertion that current pension benefits cannot be changed, including:

- Orange County, California sued to repeal the awarding of previously granted retroactive benefits. The case was dismissed by a Los Angeles County Superior Court judge in 2009. The County has appealed that decision.
- The states of Colorado and Minnesota each changed the formula for calculating COLAs in their pension systems. Subsequently, lawsuits were filed by retirees challenging the legality of the changes. As of August 30, 2010, there had not been rulings in the Colorado or Minnesota cases.

In May 2008, the City of Vallejo, California filed for bankruptcy under Chapter 9 of the U.S. Bankruptcy Code. Under the filing, Vallejo listed the two largest unsecured claims against the city as retiree health benefits and unfunded pension obligations.<sup>37</sup> As part of the bankruptcy workout plan adopted by Vallejo's City Council in December 2009, the City sought to reduce retiree health care benefits but left existing pension benefits alone.<sup>38</sup>

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### **The City May be Able to Reduce Costs Through Negotiations with Employee Bargaining Groups**

As discussed earlier, the retirement funds have substantial assets set aside to fund future pension benefits, but not enough to avoid significant outlays in the future to reach full funding.

In combination with future budget and service reductions, the City will most probably seek to reduce pension costs through negotiations. This is what occurred during the FY 2010-11 budget process. To reduce costs, the City proposed a variety of concessions from employee bargaining units that would reduce the City's pension costs, including:

- Additional retirement contributions to help offset the City's annual contributions towards the plans' unfunded liabilities
- Reductions in employee base pay (upon which future benefits are based)

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<sup>37</sup> Vallejo's unfunded retiree health benefit obligations totaled \$135 million and unfunded pension obligations totaled \$84 million. By comparison, Vallejo's total General Fund revenues in its FY 2008-09 Proposed Budget were about \$80 million.

<sup>38</sup> In March 2010, Vallejo approved a new contract with its firefighters that reduced benefits for new hires but did not touch benefits of existing employees.

### Increased Cost Sharing Between the City and Employees

As has already been seen, one alternative is increased cost sharing. Negotiations between the state of California and some employee bargaining groups led to increases in the amount employees would contribute for their pensions. Similarly, other local governments have negotiated with employee bargaining groups and increased employee contribution rates. Exhibit 31 shows selected cities and one state employee bargaining group who have raised employee contribution levels (note: similar to San José employees, these groups do not contribute to Social Security).

**Exhibit 31: Selected Increased Cost Sharing Agreements, Other Governments and Bargaining Groups<sup>39</sup>**

	Change in Employee Contribution Rate
City of Palo Alto miscellaneous employees	Raised from 2% to 8%
City of Oakland Police (subject to approval of parcel tax by Oakland voters)	Raised from 0% to 9% over three years
City of San Francisco public safety (new employees)	Raised from 7.5% to 9%
California Highway Patrol	Raised from 8% to 10%

Source: City Auditor analysis of information from Memoranda of Understanding, Election Results, and news articles

It should be noted for comparison that San José current employee contribution rates including OPEB are already 15.57% for Police members, 13.7% for Fire members, and 10.3% for Federated members.<sup>40</sup>

San José employees share in the *normal cost* of their pensions, on an 8:3 ratio specified in the Charter. On the November 2010 ballot there is a measure to amend the City Charter that would, among other things, allow the City Council to provide a retirement plan or plans to new employees that are not subject to the Charter's minimum requirements, including the 8:3 contribution ratio.

The Charter does not specify how the cost of the *unfunded liability* is to be shared. Currently, employees share in the current year or estimated *normal cost* of benefits, but historically the City has borne the full burden of paying for any *unfunded liabilities*. Beginning in 2010, some bargaining groups will be picking up a negotiated share of that burden, offsetting the City's payments towards the unfunded liability. It should be noted that these agreements do not result in any additional contributions towards the unfunded liability; only a redistribution of who pays.

<sup>39</sup> Each of these agreements were part of larger pension reform measures which also reduced benefits or changed the calculation of final compensation for new hires.

<sup>40</sup> These rates are before any negotiated employee pickup of a portion of the City's contribution as a result of negotiations with bargaining units for the FY 2010-11 Budget as described in Chapter 3.

**Consideration Should be Given to Eliminating the SRBRs or at Least Prohibiting Transfers of "Excess Earnings" and Distribution of Supplemental Benefits When the Plans Are Underfunded**

As described in Chapter 5, the SRBRs provide supplemental benefits to retirees which are derived from plan "excess" earnings. This can take place even when the plans are underfunded. As was seen in Exhibit 27, the SRBRs account for about 4 percent of the total costs of each plan. The Federated SRBR was established in 1986. The Police and Fire SRBR was established in 2001 and commenced distribution in 2002. In our opinion, elimination of this practice is necessary to preserve and protect the retirement plans.

**Prospective Changes to Retirement Plans Are Allowable in Exchange for Commensurate Benefits**

An exception to the perceived rule against changing certain benefits of active members can occur if, in exchange for a benefit reduction, a commensurate benefit is provided. In 2010, this occurred in Vermont where state teachers agreed to a later retirement age in exchange for an increase in the maximum allowable benefit.

As noted previously, as a result of recent budget deficits, many City employees' base pay and employee benefits have been reduced, others are paying more than 20 percent of their wages and salaries in pension contributions, and 191 employees were laid off. At the same time, regular employee contribution rates for retirement and OPEB costs have increased as well. As budget deficits are forecast into the future, City employees may find the combined impacts from the annual budget process, negotiations related to concessions, and rising contribution rates overly costly and personally unsustainable.

For example, faced with negotiating based on their total compensation (where retirement benefits are included along with base pay and other benefits), some employees may prefer any reductions to their total compensation be balanced between income and benefits. For example, reducing base pay and increasing retirement contributions each have the effect of reducing an employees' take-home pay. Faced with difficult choices, employees may choose to agree to things that do not affect net pay to cover other needs such as saving to purchase a home.

The willingness and ability of bargaining units to agree to a particular concession can be dependent upon where the employees they represent are in their careers and what they expect or prefer in a pension. For example, an individual nearing retirement may be less interested in changes to their plan than an individual just beginning their career. For this reason, the agreement in Vermont to raise the retirement age did not affect teachers who were within five years of retirement.

Some employees, particularly those with only a few years in the system and/or who may not view a 30-year career with the City as a likelihood, may put more value on a plan that allows more portability and self-direction than the current system. As was the case in Vermont, some employees may prefer a later retirement age in exchange for something else. In San José, that could mean reduced current contributions into the system, increased portability, or some other consideration.

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### The City Should Explore a Second Tier for New Employees

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The Charter provides for the minimum pension benefits the City must provide for employees. On the November 2, 2010 ballot there is a measure to amend the pension provisions in the City Charter. If approved, the City Council would have the ability to establish second tier retirement plans for new employees that are not subject to the Charter's minimum requirements. Other jurisdictions already have multiple tiers within their pension systems.<sup>41</sup>

The City Manager's Associations of Santa Clara and San Mateo County have recommended that cities in the region implement a second tier of benefits for new employees. CalPERS and some local jurisdictions (e.g. San Francisco, Oakland, Palo Alto, San Carlos, South San Francisco, and Campbell) already have created second tiers for new hires.<sup>42</sup> Some of the changes in benefits include:

- Raising the retirement age from 50 to 55 for public safety employees and 55 to 60 for miscellaneous employees
- Reducing the benefit formula to 2 percent of final compensation times years of service
- Changing the definition of final compensation to the average of the highest three years rather than highest one year

Some jurisdictions have implemented 401(k) style defined contribution plans<sup>43</sup> (e.g. Alaska) or hybrid systems with both defined benefit and defined contribution plans (e.g. Washington, Utah, and Michigan). When these types of plans are implemented, current employees are often allowed to opt into them.

Local governments are only exempt from having their full time employees participate in the Social Security system if they provide a plan that meets certain minimum standards. In addition, in order for employee contributions to be made

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<sup>41</sup> For simplicity, when we refer to second tier benefits, we are referring to a plan's most recent tier which includes a reduced level of benefits than previous tiers.

<sup>42</sup> Oakland's second tier is contingent upon voter approval of a parcel tax ballot measure in November 2010.

<sup>43</sup> We are using the term "401(k) style defined contribution plans" because 401(k) plans, in particular, cannot be implemented by governmental agencies that did not have them in place in 1986.

into a retirement plan on a pre-tax basis, the plan must meet Internal Revenue Code requirements, including the requirement that it provide a "definitely determinable benefit" to employees.

As a result, a straight 401(k) style defined contribution plan is not an option for the City; but Social Security could be. The City could opt to participate in Social Security and pay 6.2 percent of payroll into the Social Security Trust Fund (potentially supplemented with a defined contribution plan). As was noted in Chapter 1, Redevelopment Agency staff who are not City employees participate in a defined contribution 401(a) plan in which the Redevelopment Agency contributes 9 percent of base salary and makes payments into Social Security, and employees contribute 3 percent of base salary and also make payments into Social Security.

#### **Considerations for Second Tier Benefits**

In developing a policy for second tier retirement benefits, the City will need to consider a number of factors, including:

- Purpose of plan:
  - City's perspective – attract and retain a quality workforce
  - Employee perspective – future replacement income (Money magazine cites a retirement income target (from all sources) of 70 percent of pre-retirement income to live comfortably in retirement)
- Affordability of the plan
- Are employees covered by Social Security or offered other supplemental savings plans?
- Portability of retirement assets and/or reciprocity with other California public pension systems
- Who bears the risk (i.e. investment risk or the risk of not meeting other assumptions)?

#### *Workforce Development Concerns in Designing a Second Tier*

The City's defined benefit plan is designed to reward longevity and promise a fixed benefit for life in retirement. It encourages retention because the benefit becomes more valuable as the employee ages and stays more years with the City. As a retirement plan task force in Maine recently reported:

*A major consideration for... evaluating a second tier plan is who is it designed to benefit and why? If the goal is to solely to encourage employee longevity, the traditional defined benefit plan is the answer. If the goal is to attract and hire younger employees, a defined contribution plan is a likely option. If the goal is to create portability of benefits so that*

mobile employees can build a retirement income, then Social Security with a supplemental defined contribution plan, or to a lesser extent, a defined benefit plan may fit the need.<sup>44</sup>

The large number of anticipated baby boomer retirements, and the significant replacement hiring that may occur to backfill those positions, requires that the City has a system that will continue to be attractive to incoming talent – even as the City attempts to reduce costs. According to some observers, a new generation of employees may have different desires and expectations of career paths and compensation tradeoffs. While the need for cost reduction may be what is driving the change, a desirable result should also be a revised system that aligns to employer and employee needs into the future.

#### *Alternate Plan Designs*

Exhibit 32 lists some commonly understood advantages and disadvantages of alternate plan designs. The important consideration of plan affordability would depend upon the specifics of the plan.

**Exhibit 32: Advantages and Disadvantages of Alternate Plan Designs**

	Advantages	Disadvantages
Defined benefit plan	<ul style="list-style-type: none"> <li>- Guaranteed lifetime benefit to employees</li> <li>- Motivates employees to continue in service</li> <li>- Generally more expensive overall, but more efficient than defined contribution plans at providing benefits on a per dollar of benefit paid basis<sup>45</sup></li> </ul>	<ul style="list-style-type: none"> <li>- Employer bears all of the risk</li> <li>- Limited portability of benefits</li> <li>- Cost of plan can fluctuate from year to year as a result of actuarial projections</li> </ul>
401(k) style defined contribution plan (in combination with Social Security)	<ul style="list-style-type: none"> <li>- Employer costs are limited</li> <li>- Annual contribution amount is easily determined</li> <li>- More portable than defined benefit plan</li> </ul>	<ul style="list-style-type: none"> <li>- Employee bears risk of outliving accumulated assets and market returns</li> <li>- Does not provide same motivation to continue service as defined benefit plan</li> </ul>
Hybrid plan (with defined benefit and defined contribution characteristics)	<ul style="list-style-type: none"> <li>- Depends on plan design</li> <li>- Flexibility in sharing risk associated with pension obligations</li> </ul>	<ul style="list-style-type: none"> <li>- Depends on plan design</li> </ul>

Source: Auditor analysis

<sup>44</sup> Maine Unified Retirement Plan Task Force, *Task Force Study and Report Maine State Employee and Teacher Unified Retirement Plan* (March 2010).

<sup>45</sup> According to Gabriel, Roeder, Smith & Company, the Federated plan's actuary, this is because individuals in defined contribution plans need to invest more conservatively as they grow older and accumulate assets to finance benefits. Defined benefit plans do not have to alter their investment mix over time and can spread the risks of mortality over their members' lifetimes.



## Pension Sustainability

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### *Potential Cost Savings From Establishing a Second Tier May be Minimal in the Short-Term*

Because second tiers generally apply only to new hires, cost savings may be minimal in the near term but grow in future years because of employee turnover. This is because the normal cost and the continued amortization of the unfunded liability for the first tier must still be paid. Nonetheless, as an estimate of how quickly savings could be achieved, about 20-25 percent of employees would be included in the second tier in five years if San José's employee turnover in the future is the same as in recent history.

Allowing current employees to opt into the second tier could further reduce pension costs. Opting-in could benefit current employees in the form of lower pension contributions – particularly if it had been negotiated that first-tier employees would share in the cost of the unfunded liability. Under those circumstances, employees might want the option to take a lower future benefit in exchange for more income now.

### *Potential Impact on Contribution Rates*

Although a second tier would reduce pension costs, it could have an adverse impact to contribution rates for remaining first tier members. This could occur if the annual cost to pay down the unfunded liability was spread across a diminishing number of employees. Ironically, the same thing happens with layoffs. Layoffs reduce the salary base, potentially increasing the required contribution rates for the remaining employees.

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## **There is a High Cost to Self-Administer a Pension Plan**

Self administering a pension plan is costly for local jurisdictions. San José is one of only a handful of California cities that administer their own pension system. The majority of the state's cities and counties are members of CalPERS.

In FY 2008-09 the combined administrative expenses of the Police and Fire and Federated plans totaled about \$5 million, or about 2.6 percent of total contributions. In comparison, the administrative expenses of the Sacramento County Employees' Retirement System and the San Bernardino Employees' Retirement Association were about 2.6 percent and 3.0 percent of total contributions, respectively.

Comparatively, because CalPERS is able to spread its costs across a larger pool of participants, the City would have been charged about \$1.4 million in

administrative fees (or 1 percent of total contributions) if it was a member of CalPERS.<sup>46</sup>

CalPERS offers multiple benefit packages from which local governments can choose; the packages are generally comparable to the City's current benefit structure. CalPERS offers separate packages for two categories of employees: public safety and miscellaneous.

If a city with an existing pension plan opted to join CalPERS, they could either transfer all of their active and retired members with all prior service costs, or transfer all active members going forward (with the city continuing to administer the benefits for costs associated with past service). A city could also transfer just one of the categories of employees but not the other (e.g. a city could opt to have CalPERS administer its pension plan for public safety employees but not for its miscellaneous employees).

There are challenges associated with joining CalPERS and achieving potential cost savings, including:

- To fully achieve cost savings, the Retirement Boards would need to transfer all prior service costs (i.e. costs already earned) to CalPERS. This would require a 2/3 majority vote of all retirement plan members. If all prior service costs were not transferred, and only a portion of employees moved to CalPERS, the City would end up paying CalPERS administrative fees and incurring its own expenses administering the prior service costs.
- Employee and employer contributions would be set by CalPERS.<sup>47</sup>
- The City would rely on CalPERS to invest plan assets.
- The City might be required to continue to administer medical and dental benefits for some time.
- Upfront costs of transferring prior service costs would be about \$300,000 (\$25 per member).

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### Pension Obligation Bonds

Pension Obligation Bonds (POB) are taxable bonds other California jurisdictions have issued to finance some or all of their unfunded liabilities. POBs can lead to

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<sup>46</sup> As annual contributions are projected to rise in the future, administrative fees that CalPERS would charge would rise. Similarly, as the City's personnel costs rise, the City's retirement plans' administrative costs would also rise. The differential between the CalPERS costs and self-administering the plans would vary accordingly.

<sup>47</sup> The contract with CalPERS would not impact the City Charter mandated 8:3 contribution ratio nor the City or employee bargaining groups ability to negotiate contribution rates within the Charter parameters.

## Pension Sustainability

cost savings if the interest paid on the POBs is less than the rate of return earned on retirement fund assets.

The GFOA recommends that local governments use caution when issuing POBs as they present risks.<sup>48</sup> Principal among these is investment risk (i.e. if the pension plan earns less than the interest paid on the POBs, then they become a net cost to the issuer).

In May 2010, the City Manager reported to the Council that (1) it was imperative that they understand the market risks of POBs and (2) they were not a viable tool to address the FY 2010-11 budget deficit. We agree with this assessment.

## Moving Towards Sustainability

The City has recognized that retirement reform is essential to the long-term sustainability and availability of retirement benefits for City employees. In our opinion, it is important that the City move aggressively to rein in pension costs that threaten the stability of the General Fund and the services it provides to the residents of San José. It is important to start somewhere, and it is important to start now.

**Recommendation #3: We recommend the City Administration pursue at least one or a combination of pension cost-containment strategies, including:**

- a) Additional cost sharing between the City and employees
- b) Eliminating the Supplemental Retirement Benefit Reserves (SRBRs) or at least prohibiting transfers in and distribution of "excess earnings" when the plans are underfunded
- c) Negotiating with employee bargaining groups for changes to plan benefits for existing employees
- d) Establishing a second tier pension benefit for new employees
- e) Considering whether to join the California Public Employees Retirement System in order to reduce administrative costs

**The Administration should work with the Office of Employee Relations on potential meet-and-confer issues that such changes would present.**

<sup>48</sup> For more information, see the GFOA's advisories "Evaluation the Use of Pension Obligation Bonds (1997 and 2005) and "Need for Considerable Caution in Regard to OPEB Bonds" (2007) available at [www.gfoa.org](http://www.gfoa.org). A GFOA advisory identifies specific policies and procedures necessary to minimize a government's exposure to potential loss in connection with its financial management activities, and should not to be interpreted as GFOA sanctioning the underlying activity that gives rise to the exposure.

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**Additional Actuarial Review of Changes Before Approval Should Ensure Complete Understanding of Their Long-Term Impacts**

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The question of what is acceptable and what is affordable will require detailed analysis. The GFOA advises that benefit enhancements should be actuarially valued before they can be approved in order to ensure a complete understanding of their long-term financial impacts. We agree with this policy should be followed for all benefit changes to existing plans, including options for second tiers.

OER is responsible for negotiating on behalf of the City with employee bargaining units regarding wages and other terms of employment. Currently, OER contracts with actuaries to cost out employee benefits as necessary (e.g. during negotiations with employee bargaining groups). However, OER does not currently have an ongoing budget for actuarial services. Because of rising pensions costs and their threat to the General Fund, we believe that OER should have a dedicated budget for actuarial services so that it can have available such services when the City begins negotiations with the bargaining units regarding retirement benefits.

In our opinion, this type of expert advice will be critical to ensure that the City is fully aware of the potential risks and liabilities such changes represent. Furthermore, independent review and advice will help the City and all stakeholders assess the potential impact of changes in actuarial assumptions and the sustainability of benefit changes. This will facilitate the City Council, on behalf of taxpayers, taking a more active role as the plan sponsor and guarantor of the City's pension plans.

**Recommendation #4: To obtain independent, expert advice on pension risks and liabilities, the City Manager should propose an annual ongoing budget for actuarial services.**

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## **Chapter 7    The City Will Continue to Face Considerable Financial Risks From Rising Pension Costs for Years to Come**

### **SUMMARY**

There is a risk that even if the City implements the previous recommendations, pension costs may still be unsustainable. Because of the risks of rising pension costs to the City's financial and budgetary future, we recommend that the Retirement Services Department provide an annual report to the City Council that includes updates on the financial status of the plans, forecasts of pension costs, and sensitivity analyses showing best and worst case scenarios. This should be a supplement to the City Manager's Budget Office's *Five-Year Economic Forecast and Revenue Projections for the General Fund and Capital Improvement Program*. In addition, the Retirement Services Department should ensure that each City Councilmember receive both plans' Comprehensive Annual Financial Reports (CAFRs).

The City can also improve its communications with plan members regarding the plans' performance and financial health. In addition to the CAFR, some local governments prepare annual summary reports which provide financial and actuarial data found in the CAFRs in an easily accessible format. We recommend that the Retirement Services Department prepare an annual summary report to be distributed to all plan members and posted on the Department's website.

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### **The City Council Should Receive Annual Updates on the Retirement Plan's Performance, Impact of Reforms, and Forecasted Pension Costs**

There is a risk that even if the previous recommendations are implemented, pension costs may still be unsustainable. As of June 30, 2009, the unfunded liability of the plans calculated using the market value of assets totaled \$2 billion, or about \$1 billion more than that using the actuarial value of assets. The future is also unpredictable, and lower than expected investment returns and other outcomes differing from actuarial assumptions could add to the unfunded liability as they did in the past.

Because of the risks posed to the City's financial and budgetary future from rising pension costs, we believe it is important that Council receive periodic updates on the retirement systems performance so that they can take further action as necessary.

Beginning in 2010, the Retirement Services Department has provided a quarterly investment report of the pension systems to the City Council's Public Safety, Finance, and Strategic Support Committee. Additional reporting from the Retirement Services Department to the Council would build on that work to ensure that Councilmembers are fully aware of the costs, risks, and performance of the City's retirement systems. The contents of such reporting should include an update on the financial status of the plans and forecasts of future pension costs, as well as a sensitivity analyses showing best and worst case scenarios.

The City's Budget Office prepares the *Five-Year Economic Forecast and Revenue Projections for the General Fund and Capital Improvement Program* as part of the yearly budget process. This report includes information on projected pension costs. Given the significance of the City's pension systems, we believe that supplemental and more detailed information from the Retirement Services Department is warranted.

**Recommendation #5:** To ensure the Council is fully informed on the retirement plans' performance, the impact of reforms, and pension costs, the Retirement Services Department should:

1. Ensure that each City Councilmember receive both plans' Comprehensive Annual Financial Report
2. Provide an annual report to the City Council that includes updates on the financial status of the plans, forecasts of pension costs, and sensitivity analyses showing best and worst case scenarios. This should be a supplement to the City Manager's Budget Office's *Five-Year Economic Forecast and Revenue Projections for the General Fund and Capital Improvement Program*.

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**The City Can Improve its Communication with Plan Members Regarding the Plans' Performance and Financial Health**

The City's Retirement Services website contains both plans' CAFRs which contain a wealth of information about the financial health of the plans, investment returns, and other information. The OER website contains the most recent *actuarial valuations* and other information. Although the CAFRs and the *actuarial valuations* contain much information on the retirement plans, it is not presented in a format that is easily accessible to all plan members.

In addition to recommending that local officials prepare and widely distribute their CAFRs, the Government Finance Officer's Association also recommends distributing summary information to all plan participants. According to one such report, the "goal of the Summary Report is to provide an easy to read format that allows members and others to quickly assess the financial status of the retirement system."

The summary reports include such data as:

- Plan assets and changes
- Historical data such as funding ratios, contribution rates, and plan membership for the previous decade
- Asset allocations
- Information about current plan membership with average ages, years of service, and other information of both active and retired members

These reports are posted on the plans' websites and often distributed by e-mail or mail to active and retired members.

**Recommendation #6:** To improve communication and understanding of the financial health of the retirement systems, the Retirement Services Department should prepare an annual summary report containing current and historical financial and actuarial information to be distributed to all plan members and posted on the Retirement Services Department website.



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## Conclusion

Pension benefit increases had dramatic impacts on costs even before recent market losses. Now, rising pension costs threaten the City's ability to maintain service levels. As of June 30, 2009, the City's estimated liability for pension benefits totaled \$5.4 billion—\$2 billion of that (on a market value basis) was unfunded. In addition, the City and its employees face a \$1.4 billion unfunded liability for OPEB benefits. The City's unfunded pension liability has grown dramatically in recent years, and the City will continue to face considerable financial risks from rising pension costs for years to come. Understanding how we got to this place, identifying the major cost drivers of the City's pension plans, and assessing alternatives for a sustainable future, are only first steps towards solving the problem. As we said earlier, it is important to do something about rising pension costs, and it is important to start now.

### RECOMMENDATIONS

Recommendation #1: We recommend the City Council explore prohibiting:

1. Pension benefit enhancements without voter approval
2. Retroactive pension benefit enhancements that create unfunded liabilities

Recommendation #2: To ensure the reasonableness of the methods and assumptions used in the retirement plans' actuarial valuations, we recommend that the City Council amend the Municipal Code to require an actuarial audit of such valuations every five years if the actuary conducting the valuation has not changed in that time.

Recommendation #3: We recommend the City Administration pursue at least one or a combination of pension cost-containment strategies, including:

- Additional cost sharing between the City and employees
- Eliminating the Supplemental Retirement Benefit Reserves (SRBRs) or at least prohibiting transfers in and distribution of "excess earnings" when the plans are underfunded
- Negotiating with employee bargaining groups for changes to plan benefits for existing employees
- Establishing a second tier pension benefit for new employees
- Considering whether to join the California Public Employees Retirement System in order to reduce administrative costs

The Administration should work with the Office of Employee Relations on potential meet-and-confer issues that such changes would present.

## Pension Sustainability

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Recommendation #4: To ensure that pension cost projections for negotiations with employee bargaining groups are actuarially sound, the Administration should provide the Office of Employee Relations an ongoing budget for actuarial services.

Recommendation #5: To ensure the Council is fully informed on the retirement plans' performance, the impact of reforms, and pension costs, the Retirement Services Department should:

1. Ensure that each City Councilmember receive both plans' Comprehensive Annual Financial Report
2. Provide an annual report to the City Council that includes updates on the financial status of the plans, forecasts of pension costs, and sensitivity analyses showing best and worst case scenarios. This should be a supplement to the City Manager's Budget Office's *Five-Year Economic Forecast and Revenue Projections for the General Fund and Capital Improvement Program*.

Recommendation #6: To improve communication and understanding of the financial health of the retirement systems, the Retirement Services Department should prepare an annual summary report containing current and historical financial and actuarial information to be distributed to all plan members and posted on the Retirement Services Department website.

# Memorandum

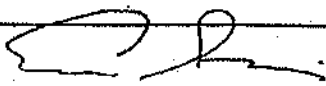
TO: SHARON ERICKSON  
CITY AUDITOR

FROM: Alex Gurza

SUBJECT: RESPONSE TO THE AUDIT OF  
"PENSION SUSTAINABILITY"

DATE: October 6, 2010

Approved



Date

10/6/10

The Administration has reviewed the audit of the sustainability of the City's pension systems and is in general agreement with the recommendations identified in the report.

Public agencies throughout the state are experiencing similar dramatic increases in costs for retirement benefits. The City and employees have experienced a significant increase in contributions from Fiscal Year 2009-2010 to Fiscal Year 2010-2011. Given recent actuarial reports, the City expects contribution rates to rise dramatically in the upcoming years. It is projected that the City's contribution rates will be approximately 45% for the Federated City Employees' Retirement System and approximately 75% for the Police and Fire Department Retirement Plan by Fiscal Year 2014-2015.

There will be significant focus on retirement reform efforts in Fiscal year 2010-2011. To initiate this effort, the City has reconvened the General Fund Structural Deficit Elimination Stakeholder Group in order for stakeholders to have input on the goals for retirement reform. In addition, the stakeholder process will provide an opportunity for education on why retirement reform is necessary. The reconvening will commence on September 29, 2010, and the work completed by the Stakeholder Group will be reported to Council in November 2010.

In addition, there is a ballot measure included in the November 2010, election that if passed would allow the City Council to adopt an ordinance to exclude future City officers and employees from any existing retirement plans or benefits and to establish retirement plans for future employees that do not provide for the current minimum requirements in the City Charter.

In January 2011, the City will be entering into negotiations with virtually all the City's bargaining units. The information provided in the audit report will be information considered by the Council when providing direction to the City Manager regarding retirement reform. Discussions regarding retirement reform may include the audit recommendations such as second tier pension benefit for new employees, increasing retirement age, the calculation of the pension benefit and additional cost sharing between the City and employees.

SHARON ERICKSON  
October 6, 2010  
Subject: Response to the Audit of Pension Sustainability  
Page 2 of 2

The City Manager's Office thanks the City Auditor's Office for its comprehensive and informative review of the City's pension systems that will serve as another source of valuable information for the City's retirement reform efforts.



Alex Gurza  
Director of Employee Relations

*For additional information on this report, contact Alex Gurza,  
Director of Employee Relations, at 535-8150.*

**EXHIBIT 2**

# LABOR UNIONS' PROPOSAL OF JUNE 18, 2010

## ARTICLE 5

## WAGES AND SPECIAL PAY

### 5.1.2 ADDITIONAL RETIREMENT CONTRIBUTION

U-7C  
6/18/10  
4:25pm

Effective June 27, 2010 through June 28, 2011, all employees will make additional retirement contributions in an amount equivalent to 10% of total compensation effective June 27, 2010. The amounts so contributed will be applied to subsidize and thus reduce the prior service contributions that the City would otherwise be required to make. The parties specifically understand that this agreement neither alters nor conflicts with the City Charter Section 1505 (c) because under this agreement, employees will be subsidizing the City's Section 1505 (c) required contribution. This employee retirement contribution is in addition to and apart from the employee retirement contribution rates established and approved by the Federated City Employees' Retirement System Board. This additional employee contribution shall be reduced by half (50%) effective the first payroll period for Fiscal Year 2012.

Any portion of the 10% total compensation figure not required to reduce prior service contributions shall be applied to subsidize and thus reduce the City's contribution for retiree medical benefits, provided however, that these additional contributions made by employees to offset the City's contribution for retiree medical benefits shall not affect the establishment of retiree health care contribution rates by the Federated City Employees' Retirement System Board.

In the event these additional employee retirement medical contributions are not implemented for any reason by September 1, 2010, or are ceased for any reason, no additional employee retirement medical contributions shall be required and the parties shall immediately reopen for the purpose of determining how the equivalent amount of effective total compensation will be achieved. If the parties do not reach an agreement after two negotiation sessions or after negotiating for at least four hours, the union agrees the City can implement the following:

*"The equivalent amount as a percentage of total compensation will be taken as a temporary base pay reduction with retroactive deductions taken as described above. (The equivalent pay % of total compensation may be different for each bargaining group.)"*

In the event that the additional employee retirement and retirement medical contributions are not implemented by June 27, 2010, the additional employee contribution will increase on a pro-rata basis over the remaining fiscal year pay periods to make up for the missed contributions. For example, if the additional contributions do not begin for the first four pay periods in Fiscal Year 2011, the employee contributions for each of the subsequent remaining twenty-two pay periods of the fiscal year will be recalculated to provide for 100% of the total compensation reduction in effect.

In order to implement this provision, the City may be required to amend the Federated City Employees' Retirement System by adopting an ordinance amending the San Jose Municipal Code.

These contributions shall be treated in the same manner as any other employee contributions. Accordingly, these additional employee contributions will be made on a pre-tax basis through payroll deductions pursuant to IRS Code Section 414(h)(2) and will be subject to withdrawal, return and redeposit in the same manner as any other employee contributions.

Part-time employees not in the City's retirement system will receive a base pay reduction effective June 27, 2010 equivalent to the effective total compensation reduction provided herein.

**EXHIBIT 3**



U → C  
5/18/10

## OE3 initial Proposal to the City of San Jose May 17, 2010

In order to assist the City of San Jose with their current financial issues the Operating Engineers proposes the following in order to reach the 10 % concession target.

Term: 2 years - July 1, 2010 - July 1, 2012

### Year 1

Employees will make a 5% tax deferred contribution in accordance with 414(h)(2) of the Internal Revenue Services Code to the Federated Retirement Fund. This contribution is intended to offset City contributions on behalf of the employee. (estimated saving including actuarially assumed contribution increases 7.5%)

Maintain the current pay rates of all employees.

Eliminate all part time employees within the classifications covered by Bargaining Unit 61 ( Estimated savings 3%)

Continue Step Increase freeze. (Estimated savings 1%)

All other provisions of the collective bargaining agreement remain in effect.

### Year 2

Continue 5% employee tax deferred contribution to the Federated Retirement Fund. ( estimated savings 7.5%)  
Sunssets July 1, 2012.

No retire of part time employees. (estimated savings 3%)

Step increases unfrozen January 1, 2011. (estimated savings 0.5%)

All new hires after July 1, 2011 will be enrolled in a Voluntary Benefits Association (VEBA)

All other provisions of the collective bargaining agreement remain in effect

No full time permanent employee lay offs for the term of the agreement

Year 1 savings 11.5%

Year 2 savings 11%

GURZA000082

OE 3's Last, Best and Final Offer to City of San Jose

June 11, 2010

HEALTHCARE

Effective July 1, 2010, co-pays for all HMO plans shall be as follows:

- a. Office Visit co-pays shall be increased to \$25.00
- b. Prescription Co-pay shall be increased to \$10 for generic and \$25 for brand name
- c. Emergency Room Co-pay shall be increased to \$100
- d. Inpatient/Outpatient procedure shall be increased to \$100

Payment-In-Lieu of Health and Dental Insurance

Effective June 27, 2010, employees who qualify for and participate in the payment-in-lieu of health and/or dental insurance program will receive the following per pay period:

	Health-In- Lieu	Dental-In-Lieu
if eligible for family coverage	\$221.84	\$19.95
if not eligible for family coverage	\$ 89.09	\$19.95

A City employee who receives healthcare coverage as a dependent of another City employee or retiree shall be deemed not eligible for family coverage.

Additional Retirement Contribution

OE 3 agrees to making an additional pension contribution of 7.5% for 2 years. The City would reduce its contribution to the Federated Retirement System by a commensurate amount and save millions of dollars each year.

Strengthening the Retirement Systems

The parties agree that they shall participate, on an equal basis with all other bargaining units in their respective Retire Systems, in a joint labor management study regarding retirement benefits and the need to make changes in such benefits for prospective employees.

The labor management study shall issue a report on possible change by no later than April 1, 2011. The Memorandum of Agreement shall then reopen for negotiations over retirement benefits for prospective employees. The provisions of the no-strike clause of MOA shall be suspended as applied to these negotiations.

GURZA000083

UAC

3/7/11

## **2011 City of San Jose - OE 3 Negotiations**

### **OE 3 Proposal - Term of Contract and Compensation**

The intent of this proposal is to make the 5% one-time and 5% the ongoing Additional Retirement Contribution from Local 3's 2010-2011 MOA ongoing for a total of 10% ongoing compensation concession.

Operating Engineers Local 3 proposes the following:

- The vacation accrual rate shall be reduced by two (2) hours per pay period during the term of this contract. (approximately 3% savings)
- For the term of this contract, all Local 3 represented employees will work a 38 hour work week. The 2 hours may be banked and may be taken in 8 hour increments with supervisor approval and will have minimal impact on service delivery. (approximately 5% savings)
- The 5% ongoing Additional Retirement Contribution shall be reduced to 2% for the term of this contract. (2% savings). The one time 5% Additional Retirement contribution will be eliminated.
- The salary step reduction will cease for the term of this contract.

**The term of this Contract - 2 years, July 1, 2011-June 30, 2013**

The 10% Total Compensation Proposal is one component of Local 3's package proposal and will be taken in its entirety to the Membership addressing all outstanding issues.

Should any City employee bargaining unit, represented or unrepresented not provide the 10% total compensation, as directed by City of San Jose City Council, the same lower compensation concession, in any form or manner, will be applied to Local 3 bargaining unit.

Local 3 reserves the right to modify, edit or amend proposals during the course of negotiations

March 3, 2011

GURZA000084

## Union Package Proposal #1 March 24, 2011

Term: July 1, 2011 to June 30, 2013

Compensation: Maintain current base pay  
reduction of 3.35%

5% additional retirement  
contribution calculated FY 09/10  
base pay

Reopener should any other bargaining group  
concedes less 10 %

Health Care Cost Sharing: 85/15 and City to offer OE 3  
Medical Plans to OE 3 represented  
employees

Health and Dental in Lieu: Agree to City Proposal

Health care Dual Coverage: Agree to City Proposal

Certificate Pay: Union Proposal

Holiday Pay: Union Proposal

Arbitration Costs: Union Proposal and costs  
associated with Arbitration be  
shared equally by Union and City

Safety: Union Proposal

Documented Oral Counseling: Union Proposal

**Local 3 reserves the right to modify, edit or amend proposals during  
the course of negotiations**



International  
Electrical



Brotherhood  
Workers

AFL-CIO

Local Union No. 332

2125 CANOAS GARDEN AVENUE, SUITE 100

SAN JOSE, CALIFORNIA 95125

Telephone: (408) 269-4332

Fax: (408) 979-5500

Date: May 14, 2010

To: Jennifer Schembri

From: Sal Ventura and IBEW-332 Negotiating Team

Re: IBEW 332 Contract Proposal

Our members have heard the public outcry to protect city services and our proposal is designed to do just that. IBEW's 80 members are committed to help protect city services for San Jose residents and protect the employees who deliver those services. The IBEW proposal of \$571,695 thousand per year *exceeds* the Council's 10% General Fund savings target of \$441,390 thousand dollars.

Our *Retirement System Stability Proposal* accomplishes four key goals:

1. An additional 7.5% of our member's base pay will come off our checks and go into the federated retirement fund. This additional retirement contribution will place a higher financial burden on our members to fund our retirement.
2. The City would reduce its retirement contribution for our members by a commensurate 7.5%, generating substantial on-going general fund savings for multiple years.
3. Zero wage increases will generate additional savings for the City in pension costs. Because the Federated retirement system *assumes* our members will receive a 4.25% raise per year, multiple years of zero wage increases will reduce the city contributions necessary to fund the pension system.
4. Because our proposal spans the course of two years, the City will realize ongoing savings for this fiscal year and the following fiscal year. This is a prudent, long-term fiscal strategy for the City.

Effective July 1, 2010, all unit employees will contribute 7.5% of base pay towards prior service retirement costs. This payment will be made on a pre-tax basis through payroll deduction pursuant to IRS Code Section 414(h)(2). This contribution shall be credited to an employee's individual account for purposes of refunds, where such refunds are required or permitted under the Plan to be given to an employee. This contribution shall terminate effective June 30, 2012.

GURZA000086

Page 2

IBEW 332 Contract Proposal

The City would reduce its required retirement contribution rate by a commensurate 7.5% for all unit employees for the term outlined above.

As was directed by the City Council in adoption of the March Budget Message for Fiscal Year 2010-2011; "To the extent possible, concessions from non-sworn bargaining units should primarily be used to save non-sworn positions, and savings from the sworn bargaining units should be primarily be used to save sworn positions."<sup>1</sup>

As such, the City will utilize the savings generated from the proposal above to follow, not just the letter of the direction given by Council, but the spirit of the direction given by the council and utilize these savings to save jobs within the IBEW bargaining unit.

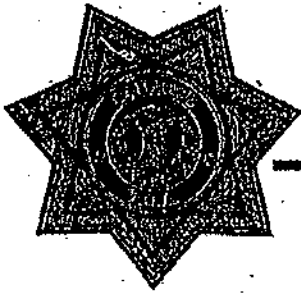
Local 332 reserves the right to add to, modify, or delete proposal during negotiations.

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<sup>1</sup> March Budget Message for Fiscal Year 2010-2011, March 12, 2010. Page 7.







# SAN JOSE POLICE OFFICERS' ASSOCIATION

1151 North Fourth Street • San Jose, California 95112  
Telephone 408-298-1133 • Facsimile 408-298-3151 • E-Mail@sjpoa.com

May 17, 2010

Received  
City Manager

MAY 20 2010

Office of  
Employee Relations

Alex Gurza  
Director of Employee Relations  
City of San Jose  
200 E. Santa Clara Street  
San Jose, CA 95113

Re: San Jose Police Officers' Association (SJPOA) Package Proposal No. Two

Dear Alex:

We are in receipt of your letters dated May 5, and May 7, 2010. We appreciate the City's continued willingness to engage with SJPOA as we seek to reduce costs and alleviate the City's ailing financial condition in a way that both preserves the greatest number of police officer jobs to protect the citizens of San Jose, and avoids cuts in other City services. Our task is a challenging one.

To recap, SJPOA believes that its proposal as presented, verbally, on April 26, 2010 and clarified on May 4, 2010, was a major concession and went a long way (if not all the way the City wanted) towards helping the City address its budget difficulties. Under the proposal, we estimate that the City's police officers would be sacrificing well in excess of \$7 million in fiscal year 2010-11.

During our meeting of May 6, 2010, the City made a counterproposal. Unfortunately, that proposal gave little if any ground from the City's prior packaged proposal—and we are gravely concerned about the City's unwillingness to move at all from the artificial "10% total compensation reduction" goal it has demanded from the outset of these negotiations.

Notwithstanding these concerns, and the merits of our April 26/May 4 proposal, SJPOA would like to discuss with the City an alternative proposal. Substantively, it would run along these general lines, with the specifics to be hammered out at the table:

- ☐ The length of the contract would be for two years;
- ☐ There would be no wage increases;
- ☐ The City would agree to abide by the provisions of the Public Safety Officers' Procedural Bill of Rights Act (a "no-cost" item);
- ☐ The promotional "rule of ten (10)" would change to a "rule of five (5)" (again, at no cost to the City);

Alex Gurza  
May 17, 2010  
Page 2

- ☐ SJPOA-represented employees would make the following contractually agreed additional member retirement contribution:
  - o Members would contribute—pre-tax—five percent (5%) of their base pay which would be transferred to the Police & Fire Retirement System, as an additional member contribution to prior service retirement costs. We believe that this would permit the City to reduce its retirement costs by the same amount—thereby realizing savings of \$7.909 million per year to the City for two years.
  - o Additional savings to the City of approximately \$2.625 million per year are reaped from the 0% salary proposal, because the Police & Fire Retirement System assume a 4.25% annual salary increase.
  - o The additional retirement contribution would “sunset” on June 30, 2012.
- ☐ Finally, there would be no layoffs in the bargaining unit for the duration of the contract (as noted in our May 4, 2010 letter, between unfilled positions and expected retirements, by August 1, 2010, we expect the City to be operating with approximately 100 fewer police officer positions, with an ongoing cost savings to the City of \$18 million per year).

This proposal would save the City more than \$10.5 million per year, and more than \$21 million over its two-year term. This would be money coming directly out of the pockets of our members, who are themselves struggling, like many in these difficult economic times, to provide for their families, in order to help the City.

We encourage the City Council to give strong consideration to this proposal. We are available to meet this week to discuss it in more detail.

Sincerely,



GEORGE BEATTIE  
President

GB

cc: Deanna Santana, Deputy City Manager  
Aracely Rodriguez, Senior Executive Analyst  
Dave Cavallaro, Deputy Chief, San Jose Police Department



GURZA000089



## SAN JOSE POLICE OFFICERS' ASSOCIATION

1151 North Fourth Street • San Jose, California 95112  
Telephone 408-298-1133 • Facsimile 408-298-3151 • E-Mail@sjpoa.com

June 21, 2010

VIA E-MAIL AND U. S. MAIL

Alex Gurza  
Director of Employee Relations  
City of San Jose  
200 E. Santa Clara Street  
San Jose, CA 95113

RE: SJPOA's Concessionary Proposal Dated 6-21-10

Dear Alex:

I am writing to inform you that the offer the City rejected from San Jose Police Officers' Association's proposal, made on Friday, June 18 has been modified to a one (1) - year term. The City's rejection on June 18 of our proposal was based, as you explained, on the fact that the proposal includes a two (2)-year term, rather than a one (1) -year term, of duration. We have decided to accept your proposal to have the one (1) -year term. We hope now that we have a deal.

Aside from the one-year term, our proposal made the following concessions:

- (1) No wage increases
- (2) SJPOA bargaining unit members would contribute, pre-tax, 5.25%, per annum, of their base pay which would be transferred to the Police and Fire Retirement System as an additional member contribution to prior service retirement costs. (This provision would sunset with the expiration of the MOU in 2011.)<sup>1</sup>

(3) Healthcare Co-pay

- Effective July 1, 2010, co-pays for all available HMO plans shall be as follows:
  - a. Office Visit Co-pay shall be increased to \$25

<sup>1</sup> Language that would effect the implementation of such increased retirement contributions was discussed in theory by the City and the POA, and POA General Counsel John Tennant addressed concerns you raised (1) as to the legality of the deductions and (2) as to whether the amounts would be accurate from the Retirement Board actuary's point of view. Mr. Tennant is providing you under separate cover with the precise language discussed which addresses your concerns.



GURZA000090

**EXHIBIT 6**

---

**From:** Randy Sekany [president@sjff.org]  
**Sent:** Tuesday, June 08, 2010 8:18 AM  
**To:** Gurza, Alex  
**Subject:** New Proposal from Unions

**Attachments:** coalition letter 6-8.pdf; ADDITIONALGIVEBACKS(1)[1].pdf



coalition letter  
6-8.pdf (521 ...



ADDITIONALGIVEB  
ACKS(1)[1].pdf ...

Good morning Alex,

Please find attached a cover letter and new proposal from the coalition of seven bargaining groups. Please be advised that an original copy will be sent to you and because of the time sensitivity of the budget process these documents will also be sent electronically to the Mayor and City Council.

Thank you,

Randy

Randy Sekany, President  
San Jose Fire Fighters IAFF Local 230  
4th District Vice President  
California Professional Firefighters--

Privileged And Confidential Communication.

This electronic transmission, and any documents attached hereto, (a) are protected by the Electronic Communications Privacy Act (18 USC §§ 2510-2521), (b) may contain confidential and/or legally privileged information, and (c) are for the sole use of the intended recipient named above. If you have received this electronic message in error, please notify the sender and delete the electronic message. Any disclosure, copying, distribution, or use of the contents of the information received in error is strictly prohibited.



June 9, 2010

Alex Gurza  
200 East Santa Clara Street  
San Jose, CA 95113



RE: Saving City Services  
Additional Coalition Concessions

Dear Mr. Gurza,

Attached to this letter is a list of additional cost saving concessions our coalition of seven unions are making in an effort to save as many services and jobs from our respective unions as possible.



Our increased concessions are in the spirit of the recent Mercury News editorial that stated:

"We hope Reed can get city and union negotiators to the table for a final push to help save hundreds of jobs — and the critical public services those workers represent."

ABMEI

Our additional concessions will increase what our members pay for health care, reduce compensation for health in-lieu and begin a time certain dialogue, with a contract opener on retirement benefits for prospective employees.

AMSP

We understand that you have been unable to do anything other than follow the current City Council direction. It is our hope that by presenting these concessions that you will seek new direction so that you will be able to work with us to collectively save city services and the jobs that support those services.



Respectively,

SJPOA, SJFF-Local 230, AEA, CAMP, ABMEI, AMSP, IBEW

GURZA000092

**SJPOA, SJFF-Local 230, AEA, CAMP, ABMEI, AMSP, IBEW**  
**ADDITIONAL CONCESSIONS TO SAVE CITY SERVICES**  
**June 9, 2010**

**Healthcare Concessions**

All bargaining units in our coalition would agree to:

Effective July 1, 2010, co-pays for all available HMO plans shall be as follows:

- a. Office Visit Co-pay shall be increased to \$25
- b. Prescription Co-pay shall be increased to \$10 for generic and \$25 for brand name
- c. Emergency Room Co-pay shall be increased to \$100
- d. Inpatient/Outpatient procedure Co-pay shall be increased to \$100

**Payment In-Lieu of Health and Dental Insurance**

Employees who qualify for and participate in the payment-in-lieu of health and/or dental insurance program will receive fifty percent (50%) of the City's contribution toward their health and/or dental insurance at the lowest cost single or family plan if the employee is eligible for family coverage. The City will retain the remaining fifty percent (50%) of that contribution.

Effective June 27, 2010, employees who qualify for and participate in the payment-in-lieu of health and/or dental insurance program will receive the following per payperiod:

Health In-Lieu Dental In-Lieu

If eligible for family coverage:	\$221.84	\$19.95
IF NOT eligible for family coverage:	\$89.09	\$19.95

A City employee who receives healthcare coverage as a dependent of another City employee or retiree shall be deemed not eligible for family coverage.

**Additional Retirement Contribution**

SJPOA and SJFF-Local 230 would agree to making an additional pension contribution of 5% for two-years as described in our previous offer.

AEA, CAMP, ABMEI, AMSP, IBEW would agree to making an additional pension contribution of 7.5% for two-years as described in our previous offer.

The City would reduce its contribution to the respective retirement systems by a commensurate amount and save millions of dollars each year.

**Strengthening Retirement Systems**

The parties agree that they shall participate, on an equal basis with all other bargaining units in their respective Retirement Systems, in a joint labor-management study regarding retirement benefits and the need to make changes in such benefits for prospective employees.

This labor-management study shall issue a report on possible changes by no later than April 1, 2011. The Memorandum of Understanding shall then reopen for negotiations over retirement benefits for prospective employees. The provisions of the no-strike clause of the MOU shall be suspended as applied to these negotiations.

**EXHIBIT 7**



June 17, 2010

RECEIVED  
San Jose City Clerk

2010 JUN 17 P 12:53

Honorable Mayor and City Council  
City of San Jose  
200 East Santa Clara Street  
San Jose, CA 95113

RE: Ratification Votes as Per City Council Direction

Dear Mayor and Council,

We appreciate the wisdom and decency of the City Council majority that voted to allow our unions a few more hours to work with City staff on meeting the 10% total compensation proposal we offered on Tuesday June 15.

Yesterday, June 16, 2010 our coalition met with Alex Gurza to "discuss" the attached language that was presented to our respective memberships this morning for ratification. Since there was no representation from the office of the City Attorney at our meeting with Mr. Gurza yesterday, it is our hope that this language was reviewed by the City Attorney since Mr. Gurza raised numerous "legal" issues during the June 15 City Council Meeting.

Each of the unions listed below presented our 10% total compensation proposal to their respective memberships this morning and each of the undersigned unions have approved the attached language which reduces our members total compensation by 10%.

We respectfully ask that those on the City Council that demonstrated leadership earlier this week will once again take a leadership role and approve our proposal. It is time to get on with the business of delivering quality city services to our residents and businesses.

Name John Mukhar  
[Signature]  
ARA Authorized Signature

Name Tom Brim  
[Signature]  
ABMEI Authorized Signature

Name RAY DENISE HARKENZIE  
[Signature]  
CAMP Authorized Signature

Name Dale L. Dapp  
[Signature]  
AMSP Authorized Signature

Name San Ventura 0259  
[Signature]  
IBEW Authorized Signature

Name BILL POTE  
[Signature]  
OE3 Authorized Signature

GURZA000094

RECEIVED  
San Jose City Clerk

ARTICLE 6 WAGES AND SPECIAL PAY

2010 JUN 17 P 12:53

5.1.2 ADDITIONAL RETIREMENT CONTRIBUTION

Effective June 27, 2010 through June 28, 2011, all employees will make additional retirement contributions in an amount equivalent to 10% of total compensation effective June 27, 2010. The amounts so contributed will be applied to reduce the contributions that the City would otherwise be required to make. This employee retirement contribution is in addition to the employee retirement contribution rates that have been approved by the Federated City Employees' Retirement System Board. This additional employee contribution shall be reduced by half (50%) effective the first payroll period for Fiscal Year 2012.

Note: Additional contributions made by employees do not affect the retiree healthcare rates.

These contributions shall be treated in the same manner as any other employee contributions. Accordingly, these additional employee contributions will be made on a pre-tax basis through payroll deductions pursuant to IRS Code Section 414(h)(2) and will be subject to withdrawal, return and redeposit in the same manner as any other employee contributions.

In the event that the additional employee contributions are not implemented by June 27, 2010, the additional employee contribution will increase on a pro-rata basis over the remaining fiscal year pay periods to make up for the missed contributions.

For example, if the additional contributions do not begin for the first four pay periods in Fiscal Year 2011, the employee contributions for each of the subsequent remaining twenty-two pay periods of the fiscal year will be recalculated to provide for 100% of the total compensation reduction in effect.

The parties understand that in order to implement this provision, an amendment may be required to the Federated City Employees' Retirement System requiring an ordinance amending the San Jose Municipal Code.

In the event these additional employee retirement contributions are not implemented for any reason by September 1, 2010, or are ceased for any reason, no additional employee contributions shall be required and the parties shall immediately reopen for the purpose of determining how the equivalent amount of effective total compensation will be achieved.

Part-time employees not in the City's retirement system will receive a base pay reduction effective June 27, 2010 equivalent to the effective total compensation reduction provided herein.

GURZA000095

**EXHIBIT 8**

## CITY COUNCIL AGENDA

June 17, 2010

Special Joint City Council/  
Redevelopment Agency Meeting

City Council Agenda Items 1 through 5  
City's Last Best and Final Offers  
AEA, AMSP, CAMP, IBEW, and OE#3

[http://sanjose.granicus.com/MediaPlayer.php?view\\_id=22&clip\\_id=4370](http://sanjose.granicus.com/MediaPlayer.php?view_id=22&clip_id=4370).

Christopher Platten responding to question posed by Vice Mayor Judy Chirco.

Vice Mayor Chirco: Yes I'd like to ask Christopher Platten if he would come down. This is probably a question that's just rhetorical because we're at the point we're at.

Platten: Thank you Vice Mayor. Councilmembers, Christopher Platten?

Councilmember: Wait a minute – I think councilmember had a question for you – a specific question.

Vice Mayor Chirco: Yeah I was going to say I'd like to ask the question.

Platten: Just identifying myself for the record.

Councilmember: Thank you.

Platten: Thank you.

Vice Mayor Chirco: Were you aware that this could possibly create a problem with the City Charter?

Platten: I was aware of the Charter, I believe that there is not a problem and if I'm permitted to I'll address the questions that have been raised here today as well as the comments from the Council.

Vice Mayor Chirco: Because this isn't – as the Mayor has said, it's not a debate it's just a question/answer so you were aware but you felt it created a – the ability for the City to waive uh...

Platten: Let me say three things.

Vice Mayor Chirco: Pertaining to my question?

Platten: Yes.

Vice Mayor Chirco: Alright.

Platten: One. There is no language if you take a look at the Charter section 1504 or 1505 subparagraph c there is no language in the Charter that prohibits any agreement between collective bargaining parties to permit employees to subsidize any portion of the employer's contribution right. No prohibition, no language that says you can't do that in a collective bargaining agreement anywhere in the Charter. Number 2 the case law and unfortunately we have to go all the way back to the great depression, the case law coming from the great depression and I refer specifically to the case of *Scott v. City of Los Angeles* which I discussed briefly last night with Mr. Doyle as he indicated to you previously, was a case remarkably similar to this where the City of Los Angeles told its employees that despite their Charter and ordinance requirements to pay a certain salary, they did not have adequate fiscal resources to do so and requested that the employees waive the salary increases for a set period of time. The employees subsequently sued and the court of appeal found that waiver was effective. That of course was a 1948 decision prior to passage of the Meyers Millias Brown Act which created collective bargaining between public employees and employers so in our judgment under the law through a collective bargaining agreement you may waive a particular provision or right under a Charter. Finally number three as I tried to explain and answer this exact question yesterday to Mr. Gurza, this is an issue not of legal technicality but of political will. You have before you a proposal that clearly even if we were to set aside and agree for a moment that a certain portion of the normal cost would be subsidized by the employees, clearly the large majority would not be normal costs its prior service costs. We also have agreed that if for any reason the contributions would cease that we would begin immediate bargaining to provide the city the exact savings to the penny so the protection is there for the city if for some reason legally we're wrong about this so that's the answer I can give you Councilmember Chirco to your question.